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Perspective

Two Decades Since the Fall

On November 9, 1989, the Berlin Wall effectively ceased to exist. Remember the sequence: Communist Hungary started letting people pass into Austria and to freedom. Captives of the Soviet bloc left in droves. East Germans, too—thousands of them. The Hungarian government tried to stanch the flow, but the dam had been breached. With one dictator having resigned, a panicky East German regime began making concessions, hoping to mollify the people. They would not be placated. Thousands—and in one case, a million—took to the streets, shouting, "We want out!" Things were getting out of hand. So, on November 9, the government fumblingly announced it would lift travel restrictions to West Berlin and West Germany. It was all over but the demolition.

I don't know why it seems so much longer ago that we saw those inspiring celebrations, when East Berliners, joined by their countrymen from the western side, danced on the wall while others whacked at it with axes and sledge hammers. The crowds, the singing, the joyful cries of "Freedom!", the sections of wall toppling—I remember watching the scenes on television with my then-six-year-old, Jennifer. If you can watch them on YouTube today without tearing up, I don't know what to say.

It's hard to believe that today's 19-year-olds were born into a world without a Berlin Wall and 17-year-olds were born into a world without the Soviet Union. When my generation was growing up, the Iron Curtain and USSR seemed like permanent fixtures of life. Yes, we really did have air-raid drills in school. (Looking back, I can see they were insidious, ridiculous propaganda stunts.) Some of us wished, at most, for what was called peaceful coexistence. Others thought "we" could roll "them" back. War—which a few, amazingly, actually welcomed—would have been catastrophic beyond imagination. We dared not hope for a bloodless dissolution of totalitarianism. Yet that, more or less, is what we got.

Those of us who believe in full individual liberty have been dismayed to learn that revulsion with dicta-

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torship does not equate to a wholehearted embrace of freedom. None of the former Soviet-bloc countries has thoroughly foresworn state-capitalist welfarism, and some have traveled only a short distance along the road *from* serfdom. Central planning is dead as an ideal, but the regulatory state lives, as does what Thomas Szasz calls the Therapeutic State. This is disappointing, but it would be difficult for a resident of the United States to criticize others for failing to resist overbearing government. The longing for security, combined with the absurd notion that only ignorant and force-wielding bureaucrats can provide it, dies hard.

The fall of the Iron Curtain has been heralded as the failure of socialism, but this is a more complicated matter. Strictly speaking, there has been much less socialism in the world than it might appear since Lenin gave it up for the New Economic Policy in 1921. Remember, Marx envisioned the *abolition* of the market, including money and exchange. The economy was to be centrally *planned*—literally. But when the Bolsheviks tried it, they ended up, as Trotsky said, "staring into the abyss." Lenin was savvy enough to back away from oblivion and reintroduce aspects of the market, including a gold ruble. What followed for the next seven decades was a heavily bureaucratized, de facto quasi-market economy, existing in a world of prices in which The Plan was adjusted ex post to reflect reality and black-market "corruption" kept things going. Ludwig von Mises could not have been surprised.

Such an economy was doomed to fail, but perhaps with a little less intervention and a dollop of political freedom, it might have muddled through a bit longer. The market can put up with a lot of harassment, which means people can resourcefully get around a lot of government obstacles when they want to. Look at the U.S. economy.

★ ★ ★

The late summer and early fall were dominated by what is prejudicially called healthcare "reform." Statist analysts dominated the public discussion. A rare exception was Arnold Kling, who in this issue explains that our problems are caused by government's creation of perverse incentives up and down the line.

The government owns large shares of Chrysler and General Motors, which is a sign of how things are going these days. Michael Heberling analyzes this venture into socialist ownership of the means of production. Christopher Westley follows up with the story of Cash for Clunkers, or how the government won friends by sticking it to the poor.

Most people—and politicians—have no idea what hedge funds do, but they are sure the government should control them. Warren Gibson guides us through the thick of high finance.

So you think the government can create jobs? Then Houdini must have been able to exit a locked trunk without trickery. William Allen and William Dickneider have their doubts.

If the government could shut you away without having to justify its conduct, no enumerated right would be worth a thing. That's why habeas corpus is called the Great Writ, as Wendy McElroy explains.

Government was big on January 19, but it's growing bigger still—in ways most people don't even realize. Murray Weidenbaum is keeping score.

Composer Quincy Jones thinks there should be a cabinet department to promote the arts. Don't bet against it. Bruce Edward Walker discusses this urgent "necessity."

Our columnists have found some interesting things to tell you about. Lawrence Reed traces the end of child labor in Britain. Donald Boudreaux thinks about *Star Trek*. Burton Folsom pays some attention to President Rutherford B. Hayes. John Stossel shows healthcare "reform" won't produce competition. Walter Williams explores the rule of law. And Richard Fulmer, incessantly running into the assertion that World War II ended the Great Depression, retorts, "It Just Ain't So!"

Reviewers assay volumes on money, a neglected Antifederalist, education, and libertarian political philosophy.

—Sheldon Richman
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Child Labor and the British Industrial Revolution

BY LAWRENCE W. REED

Profound economic changes took place in Great Britain in the century after 1750. This was the age of the Industrial Revolution, complete with a cascade of technical innovations, a vast increase in production, a renaissance of world trade, and rapid growth of urban populations.

Where historians and other observers clash is in the interpretation of these great changes. Did they represent improvement to the citizens or did these events set them back? Perhaps no other issue within this realm has generated more intellectual heat than the one concerning the labor of children. Critics of capitalism have successfully cast this matter as an irrefutable indictment of the capitalist system as it was emerging in nineteenth-century Britain.

The many reports of poor working conditions and long hours of difficult toil make harrowing reading, to be sure. William Cooke Taylor wrote at the time about contemporary reformers who, witnessing children at work in factories, thought to themselves, "How much more delightful would have been the gambol of the free limbs on the hillside; the sight of the green mead with its spangles of buttercups and daisies; the song of the bird and the humming of the bee."

Of those historians who have interpreted child labor in industrial Britain as a crime of capitalism, none have been more prominent than J. L. and Barbara Hammond. Their many works have been widely promoted as "authoritative" on the issue.

The Hammonds divided the factory children into two classes: "parish apprentice children" and "free labour children." It is a distinction of enormous significance, though one the authors themselves failed utterly to appreciate. Having made the distinction, the Hammonds proceeded to treat the two classes as though no distinction between them existed at all. A deluge of false and misleading conclusions about capitalism and child labor has poured forth for years as a consequence.

"Free labour" children were those who lived at home but worked during the day in factories at the insistence of their parents or guardians. British historian E. P. Thompson, though generally critical of the factory system, nonetheless quite properly conceded that "it is perfectly true that the parents not only needed their children's earnings, but expected them to work." Ludwig von Mises, the great Austrian economist, put it well when he noted that the generally deplorable conditions extant for centuries before the Industrial Revolution, and the low levels of productivity that created them, *caused* families to embrace the new opportunities the factories represented: "It is a distortion of facts to say that the factories carried off the housewives from the nurseries and the kitchen and the children from their play. These women had nothing to cook with and to feed their children. These children were destitute and starving. Their only refuge was the factory. It saved them, in the strict sense of the term, from death by starvation."

> A deluge of false and misleading conclusions about capitalism and child labor has poured forth for years.

Private factory owners could not forcibly subjugate "free labour" children; they could not compel them to work in conditions their parents found unacceptable. The mass exodus from the continent to increasingly capitalist, industrial Britain in the first half of the nine-

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teenth century strongly suggests that people did indeed find the industrial order an attractive alternative. And there's no credible evidence suggesting that parents in these early capitalist days were any less caring of their offspring than those of precapitalist times.

The situation, however, was much different for "parish apprentice" children. Close examination reveals that the critics were focusing on *these* children when they spoke of the "evils" of capitalism's Industrial Revolution. These youngsters, it turns out, were under the direct authority and supervision *not* of their parents in a free labor market, but of *government* officials. Most were orphans; a few were victims of negligent parents or parents whose health or lack of skills kept them from earning sufficient income to care for a family. All were in the custody of "parish authorities." As the Hammonds themselves wrote, "[T]he first mills were placed on streams, and the necessary labour was provided by the importation of cartloads of pauper children from the workhouses of the big towns. . . . To the parish authorities, encumbered with great masses of unwanted children, the new cotton mills in Lancashire, Derby, and Notts were a godsend."

Though consigned to the control of a government authority, these children are routinely held up as victims of capitalist greed. But as historian Robert Hessen writes, those very children "were sent into virtual slavery by *a government body*; they were deserted or orphaned pauper children who were legally under the custody of the poor-law officials in the parish, and who were bound by these officials into long terms of unpaid apprenticeship in return for bare subsistence." Indeed, the first act in Britain that applied to factory children was passed to protect these very parish apprentices, not "free labour" children.

Though it is inaccurate to judge capitalism guilty of the sins of parish apprenticeship, it would also be inaccurate to assume that free labor children worked under ideal conditions in the early days of the Industrial Revolution. By today's standards their situation was clearly bad. Such capitalist achievements as air conditioning and high levels of productivity would in time substantially ameliorate working conditions, however. The evidence in favor of capitalism is thus compellingly suggestive: From 1750 to 1850, when the population of Great Britain nearly tripled, *the virtually exclusive choice* of those flocking to the country for jobs was to work for private capitalists.

Conditions of employment and sanitation were best, as the Factory Commission of 1833 documented, in the larger and newer factories. The owners of these larger establishments, which were more easily and frequently subject to visitation and scrutiny by inspectors, increasingly chose to dismiss children from employment rather than be subjected to elaborate, arbitrary, and ever-changing rules on how they might run a factory employing youths. The result of legislative intervention was that these dismissed children, most of whom needed to work in order to survive, were forced to seek jobs in smaller, older, and more out-of-the-way places where sanitation, lighting, and safety were markedly inferior. Those who could not find new jobs were reduced to the status of their counterparts a hundred years before—that is, to irregular and grueling agricultural labor or, in the words of Mises, "to infest the country as vagabonds, beggars, tramps, robbers, and prostitutes."

Child labor was relieved of its worst attributes not by legislative fiat, but by the progressive march of an ever more productive capitalist system.

Child labor was relieved of its worst attributes not by legislative fiat but by the progressive march of an ever more productive capitalist system. Child labor was virtually eliminated when, for the first time in history, the productivity of parents in free labor markets rose to the point where it was no longer economically necessary for children to work to survive. The emancipators and benefactors of children were not legislators or factory inspectors but factory owners and financiers. Their efforts and investments in machinery led to a rise in real wages, to a growing abundance of goods at lower prices, and to an incomparable improvement in the general standard of living. FEE

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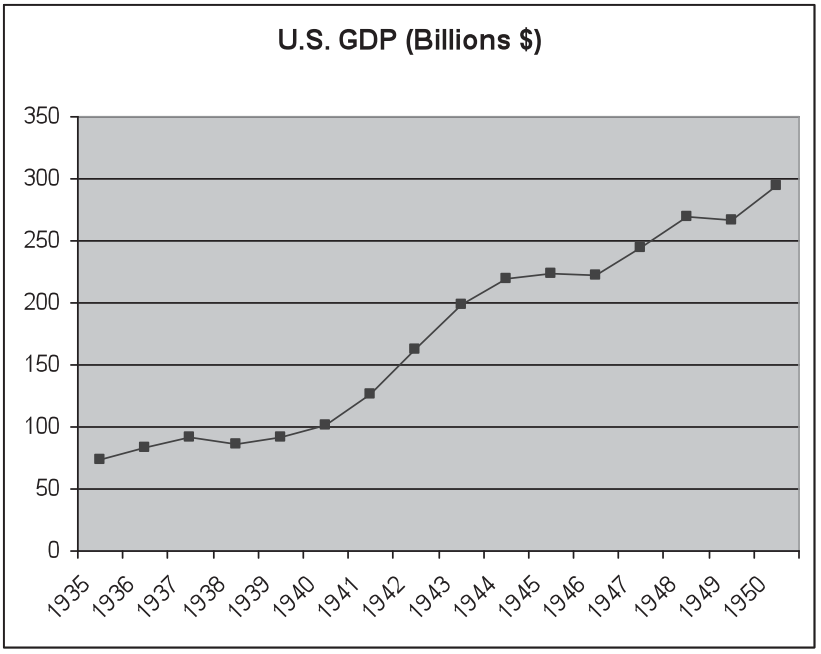
World War II Ended the Great Depression? It Just Ain't So!

BY RICHARD W. FULMER

In his 2008 book, *The Return of Depression Economics and the Crisis of 2008*, Paul Krugman writes: "The Great Depression in the United States was brought to an end by a massive deficit-financed public works program, known as World War II."

He has since repeated this bon mot in a number of columns and television appearances. Like Keynes, Krugman lets his fondness for flippant, pithy sayings get in the way of regard for long-run economic prosperity. (Keynes famously remarked that "In the long run we are all dead," ignoring the fact that in the long run others are alive.)

It is true, as the graph shows, that the country's gross domestic product rose sharply during the war.



But GDP measures only the total monetary value of production while ignoring what is actually produced. It is just a number, a number that would be no different if consumer goods were produced and sold or if the government set the workforce to making mud pies and then purchased those pies for a like sum. Yet what is produced makes all the difference. The point of an economy is to improve people's lives by producing goods and services they want and need.

During the war the P in GDP largely consisted of the munitions needed to defeat the Axis powers. While these weapons were necessary to win the war, they did nothing to provide food, clothing, and shelter. Despite all the production increases that came with the war, the American people were materially worse off while it lasted. Some 15 million American men and women, over 10 percent of the population, served in the armed forces. Living, and sometimes dying, in a foxhole was not an improvement over stateside life—even life during the worst of the Depression. Back in the States living standards also dropped (though not as dramatically) as consumer goods, including food and gasoline, were rationed.

Bridges to Nowhere But Recovery?

Krugman, however, is interested in jobs rather than production. He wants the government to spend massive amounts of money and is relatively indifferent as to how the money is spent: "Let the government

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borrow money and use the funds to finance public investment projects—if possible to good purpose, but that is a secondary consideration—and thereby provide jobs, which will make people more willing to spend, which will generate still more jobs, and so on."

This indifference is a logical outcome of his belief that the war ended the Great Depression. If, as Krugman thinks, the economy was rescued then by expending huge amounts of resources to build weapons that disappeared overseas, then we would be that much better off now if the government spent a similar amount of resources on things that have even marginal utility—say, bridges to nowhere. If the bridges provide any long-term economic benefit at all, that would just be icing on the cake.

Economically, however, World War II did not spark a recovery so much as it created a financial bubble—not in Internet stocks or housing but in munitions. Once the war was over, the bubble collapsed along with the demand for aircraft carriers and B-17 bombers.

The war's outbreak necessitated two policy changes, though, that did aid the postwar recovery. First, President Roosevelt stopped his incessant attacks on business. As Amity Shlaes points out in *The Forgotten Man*, FDR needed big business to produce the tanks, planes, and ships required to defeat Hitler and his allies. Second, he ended his erratic, trial-and-error experimentation. Before the war the stated strategy of FDR and his Brain Trust was to try one program after another until they found something that worked. This resulted in perpetual market churn that made long-term planning and investment especially risky if not impossible. Another result was the creation of myriad tiny, short-lived bubbles. Jobs were created in various locations and in various crafts only to disappear when the government lost interest and shifted its gaze.

Yet Krugman elsewhere prescribes this same strategy of experimentation for today's financial woes: "The point of all this is to approach the current crisis in the spirit that we'll do whatever it takes to turn things around; if what has been done so far isn't enough, do more and do something different, until credit starts to flow and the real economy starts to recover" (www.nybooks.com/articles/22151).

The inability of the Obama administration's deficit spending to spark economic recovery may be masked for a time by the Fed's continued expansion of the money supply.

The Don Ho School

World War II forced Roosevelt to concentrate on a single area of production: weapons. This focus was maintained for the duration of the war and resulted in a sustained economic bubble. Without a similar attention-focusing crisis, however, current government attempts at stimulus will simply result in economic effervescence—tiny bubbles inflating and bursting as the winds of politics shift lawmakers' attention. Call it the Don Ho School of Economic Thought.

The inability of the Obama administration's deficit spending to spark economic recovery may be masked for a time by the Fed's continued expansion of the money supply. Inflation could resurrect the housing bubble, providing a brief uptick in the economy, but such policies cannot be maintained for long.

What the country needs is not more economic bubbles—tiny or otherwise. It needs sustained economic growth. That will come by strengthening the private sector, not by strengthening government. The best way to do this is to reduce government spending, which crowds out the private kind, and to enact long-term tax cuts.

Contrary to popular belief, the "public works program" known as World War II did not end the Great Depression; it ended the New Deal. The end of the war brought federal spending and tax cuts and the repeal of the Smoot-Hawley tariffs. All these changes combined to pull the nation's economy out of its long and painful slide, and all could have been made without the war. Similar changes made now could restore the world's economy without the massive human suffering that, in their absence, is all but inevitable. Inevitable, yet so avoidable and so unnecessary. FEE

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Health Care's Muddled Incentives

BY ARNOLD KLING

On the topic of health care, what empirical observations are reliable? Unfortunately, many "facts" come freighted with a great deal of ideological baggage. Those skeptical of markets, who favor a large role for government in health care, tend to emphasize statistics that disparage the American healthcare system. For supporters of markets, it is tempting to try to fight back by finding data that reflects well on American health care.

I think that the best strategy is to arrive at the most accurate understanding, even if it means that America's healthcare system does not come out looking superior.

Might as well; you're not paying for it.
Wikimedia Commons: KasugaHuang

This article will summarize empirical observations that I consider important in looking at the U.S. healthcare system. First, I look at international comparisons. Next, I look at the implications of studies that compare health care in different regions *within* the United States.

Differences Across Countries

People often speak as if the healthcare system is relatively free-market in the United States and much more socialized in other developed countries. However, whether this is the case depends on how one classifies private health insurance.

About 12 percent of personal medical expenditures in the United States is paid out of pocket, which is slightly *below* that of nearly all other developed countries, including Canada. Where the United States differs significantly from other countries is in how the remaining 85–90 percent of healthcare expenditure is financed. About half that remainder is financed by private health insurance, with the other half paid for by government programs, such as Medicare and Medicaid. In other developed countries, healthcare spending is mostly financed out of a government budget.

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Private health insurance in the United States, like government health insurance, insulates the consumer from the cost of medical care. Strong regulatory and tax incentives induce businesses to include a large health insurance component in employee compensation. Looking at how private health insurance operates in this country, and why it takes the form it does, I detect considerable influence from government policy. It is hard to tell what kind of insurance, if any, would emerge in a market unaffected by government subsidies, taxes, and regulations.

Overall, I would argue that on the demand side, the United States healthcare system is essentially socialized. The fact is that close to 90 percent of healthcare spending is paid for by third parties, which means that individuals in this country generally experience a socialized process for obtaining medical services.

Private health insurance in the United States, like government health insurance, insulates the consumer from the cost of medical care.

The United States deviates most from socialized systems on the supply side. What I believe is most distinctive about the U.S. healthcare system is that it combines fee-for-service compensation for healthcare providers with fairly unlimited access to medical services. This means that supply is limited neither by rationing nor by absence of compensation nor by any fixed government budget. Notwithstanding considerable regulation of medical practice, the supply of health care is relatively unsocialized.

The combination of socialized demand and relatively unsocialized supply explains one of the key facts about health care, which is that the United States spends far more on health care than other industrialized countries. We spend close to 17 percent of GDP on it, while other countries generally spend just over 10 percent. Because our GDP per capita is also higher than other countries', the differences in healthcare spending are even more dramatic in terms of absolute dollars per capita. We spend almost twice as much per person on health care as many other industrialized countries.

This additional spending is not inherently problematic. Indeed, one would think that it is a good thing that we can afford to spend so much on medical care. Unfortunately, another fact about international healthcare comparisons is that outcomes differ very little between the United States and other countries. One can find higher survival rates in the United States for people with some forms of cancer, but overall, life expectancy does not appear to be better here.

The combination of higher spending with equivalent health outcomes suggests that the U.S. healthcare system is relatively less cost-effective than that of other countries. One can think of many possible reasons for this.

Perhaps healthcare providers earn higher rents in the United States.

Perhaps private health insurance absorbs much higher overhead than government health insurance.

Perhaps in the United States people make extravagant use of medical procedures that have high costs and low benefits.

In my view, the evidence to support (1) or (2) is very weak. Suppose we were to take away the profits of private health insurance companies and drug companies. Also eliminate the excess of what doctors are paid relative to the median salaries of other workers compared to that ratio in other countries, after adjusting for differences in specialization and hours worked. Overall, the effect on total healthcare spending would be small. I like the way David Goldhill puts it: "For fun, let's imagine confiscating all the profits of all the famously greedy health-insurance companies. That would pay for four days of health care for all Americans. Let's add in the profits of the 10 biggest rapacious U.S. drug companies. Another 7 days. Indeed, confiscating all the profits of *all* American companies, in *every* industry, wouldn't cover even five months of our health-care expenses." ("How American Health Care Killed My Father," *The Atlantic*, September 2009.)

On the other hand, one can document dramatic increases over the past 30 years in what I call "premium

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medicine," meaning medical procedures that use physical and human capital intensively. Among doctors, the number of specialists per capita has increased sharply. As an example of the use of physical capital, we now do more than 50 million CT scans and 25 million MRIs per year.

We will see below that there is strong evidence that Americans make extravagant use of medical procedures with high costs and low benefits. Thus the rise of premium medicine also coincides with a rise in wasteful spending.

Differences Within the United States

One of the most important findings in healthcare research is that *within Medicare* there are large regional variations in spending with no difference in outcomes for similar patients. The studies directly measure the amount of medical services received, such as the number of doctor visits per week. Thus there can be no doubt that the quantity and type of medical services consumed, not prices or administrative expenses, account for the large differences in spending across regions. Finally, the studies carefully control for patient characteristics, so that the absence of difference in outcomes is a reliable finding.

The studies of regional differences offer clear and compelling evidence that large variations in the utilization of medical services can be associated with no differences in health outcomes. If this is true across regions within the United States, then, in the absence of some striking piece of evidence to the contrary, I think it is reasonable to take it as true across countries as well. Again, it points to Americans' use of medical procedures with high costs and low benefits as the best explanation of why the United States spends more on health care than other countries without seeing correspondingly better outcomes.

The differences in Medicare spending across regions are striking. In contrast, the differences between the way American medicine works within Medicare and under private health insurance are small. Relative to other countries, we seem to have the same large discrepancy in spending per person among our elderly population as we do in our younger population. This is consistent with the thesis that the institutional factors that make America different are on the supply side (easier availability of treatments) rather than on the demand side (the financing mechanism). America is an outlier in terms of spending both among people insured privately and among people insured by government.

There is considerable controversy over what the regional differences in health spending—without corresponding differences in outcomes—imply about the value of medical care. At one extreme, George Mason University economist Robin Hanson argues that we could dramatically cut medical care without adverse implications for health ("Cut Medicine in Half," *Cato Unbound*, September 10, 2007, www.tinyurl.com/2ursu9).

Americans make extravagant use of medical procedures with high costs and low benefits. Thus the rise of premium medicine also coincides with a rise in wasteful spending.

On the other hand, some economists point to the tremendous value of improvements in health and longevity in recent decades. If the value of health improvements over the past 30 years exceeds $1 million per person (as Kevin Murphy and Robert Topel argue), then how can our medical services not be cost effective? (Kevin Murphy and Robert Topel, "The Value of Health and Longevity," NBER Working Paper No. 11405, June 2005.)

The discrepancy between the way health care looks if we examine differences across regions or over time can be explained in a number of ways. One hypothesis is that the big improvements in health and longevity that we have observed over the years are due to factors largely unrelated to premium medicine: better nutrition, less physical labor, better prenatal and postnatal care, vaccinations, and antibiotics.

Another hypothesis is known as the "flat-of-the-curve" theory. The idea is that medical care offers diminishing returns. The marginal benefit of the most useful treatments is high. However, as one adds more

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and more spending, the marginal benefit declines. People nonetheless keep undergoing treatments as long as they can hope for any marginal benefit, no matter how small. This means that they consume along the "flat of the curve," where the marginal benefit is close to zero.

Hanson thinks medical treatment can be harmful as well as helpful. He explains the observation that higher spending is not associated with better outcomes by suggesting that more treatment improves outcomes for some patients but worsens outcomes for others, with a net effect near zero. ("Showing That You Care: The Evolution of Health Altruism," *Medical Hypotheses,* Volume 70, Issue 4, 724–742.)

What is puzzling is we know there is considerable research and innovation in medical treatment. We also are confident that at least some of these innovations are successful. For Hanson's view to be correct, there would have to be as many harmful innovations as helpful ones. One wonders why we do not then observe the market gradually filtering out the harmful innovations and retaining only the successful treatments.

I should point out that in a market system, it would be of no concern to me whether other Americans spend their money on health care wisely or not. Whether you waste your money on ineffective medical treatments or on other consumer goods is of none of my business. Wasteful healthcare spending is a collective problem only because we have collectivized so much of what we spend.

In spite of the large presence of private health-insurance companies, one should view the American healthcare system as largely socialized on the demand side. Healthcare "reform" could entrench this socialized system even more by inducing or requiring more people who are currently uninsured to obtain policies that insulate them from the costs of their medical care. (For more on the difference between insulation and true health insurance, see chapter 5 of my book, *Crisis of Abundance: Rethinking How We Pay for Health Care*, Cato Institute.)

Wasteful healthcare spending is a collective problem only because we have collectivized so much of what we spend.

One wonders what might emerge were the government to refrain from subsidizing or regulating health insurance. If other consumers were like me, then the insurance market would be captured by companies offering policies that pay off only in the case of extreme catastrophic illness. However, if other Americans were like me, we would not have elected leaders who champion so much government involvement in health care. FEE

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Government Motors

BY MICHAEL HEBERLING

If Washington owns it, it just can't keep its hands off.
—Senator Lamar Alexander

Twenty-five years ago President Reagan told auto workers in Orion, Michigan, "You've demonstrated when the chips are down, what people can do working together freely, rather than at the dictates of some central planner or bureaucratic mandate of government. I happen to believe the last thing your industry needs is the federal government bringing in outsiders to tell you how to run a business."

Fast-forward to 2009: President Obama fires GM chief Rick Wagoner, the company files for bankruptcy, a government-appointed auto task force calls the shots, and the federal government now owns 61 percent of the new GM.

How did we get to this point and what can we expect from Government Motors?

In its heyday in the early 1980s, GM employed nearly 350,000 workers at 150 assembly plants. It also had a 43.8 percent share of the market. Unfortunately, the good times did not last.

Decades of high labor costs, foreign competition, extensive government regulation, and burgeoning legacy costs steadily reduced GM's market share to today's 19.1 percent. A shrinking market means that legacy costs will skyrocket and become unsustainable. Mark Perry at the University of Michigan–Flint estimates that the ratio of retired GM auto workers (plus surviving spouses) to active UAW members was 4.61 to 1 in 2007. Given the state of Social Security, in which fewer workers support a growing retiree population, the phrase "As GM goes, so goes the nation" seems about right.

Given the plummeting market share (averaging 0.85 percent every year), one would think at some point one of the GM chiefs would have taken drastic action to turn things around. One would think wrong. There was no financial incentive to do so. Since the GM board continually rewarded failure with mega-million-dollar bonuses (similar to the practice at AIG), why bang heads to reduce labor rates or eliminate duplicate

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product lines? GM's management apparently decided to simply stay the (downward) course, collect their golden parachutes, and hope that the inevitable wreck came on the next guy's watch.

When time finally ran out for GM in 2008, only two equally bad options appeared to be left for management: bankruptcy or government bailout. As it turned out, there was a third, even more horrible option: a government bailout bankruptcy. When you crawl in bed with the government, it's not a pretty sight. After the Bear Stearns, AIG, Freddie Mac, and Fannie Mae debacles, it became clear that government money brings some unattractive conditions, including micromanagement, the government's agenda, and political favoritism.

To oversee the restructuring of GM (and the other auto bailout recipient, Chrysler), the government established a 24-member Auto Task Force, including Obama cabinet members and White House officials. None had any experience in the auto industry. Steven Rattner, an investment banker, was appointed task force leader. According to Neil King of the *Wall Street Journal*, Rattner "ranked among [New York's] biggest fund-raisers for Democratic candidates."

One of the biggest hurdles for the task force was to reduce GM's $172.8 billion in liabilities and reallocate $82.29 billion in assets to produce a leaner, more competitive company. In normal bankruptcy the secured debt is paid off first, followed by unsecured debt. Anything left over goes to the stockholders. Unfortunately, in this case the GM stockholders came up short. In fact, there was not even enough to pay off all the unsecured debt holders. The U.S. government and UAW came out on top. The chart on the next page shows how the debt issue was finally settled.

It should come as no surprise that one of the four parties, the (unsecured) bondholders, balked at the proposed settlement terms. While they were second in the debt held, they came in last with only 10 percent of the common stock, no preferred stock, and no cash. For their objections, they were pummeled by the mainstream media and politicians. What sin did the bondholders commit? They were guilty of "greed" and of being "speculators." This clearly explained their unwillingness to negotiate in good faith.

Who Are the Bondholders?

Ironically, if we look closely at who these bondholders really are, they don't seem so ominous, threatening, or evil. As an investment, bonds are unexciting, but they are considered much safer than stocks. While bonds don't pay that much, the returns are steady. For this reason, they are popular among retirees and working families. This was especially true in the case of GM bonds. According to bond analyst Shelly Lombard, "That's because unlike most companies that issue debt in large denominations, GM sold many bonds with face values of as little as $25. That made them very attractive to average Americans." According to the *Washington Times*, mom-and-pop investors directly accounted for 25 percent of the total. Large banks and investment firms had the rest. But even here, small investors were a major player through their mutual funds and 401(k) retirement plans. Financial-restructuring authority Evan Flaschen said: "The story that hasn't been told is, this isn't GM's union retirees versus the bondholders. It's retirees versus retirees."

The government's treatment of the GM bondholders was simply disgraceful. *Investor's Business Daily* said the sordid affair "underscores why GM should have been allowed to undergo a normal bankruptcy—not the politically rigged one that the government forced down all of our throats. A regular bankruptcy would have given GM bondholders first call on its assets. Instead, they literally had money stolen from them."

At a time when we are trying to restore faith in our financial system, the government chose to run roughshod over the investor class. This near-term political expedient will have long-term negative consequences. Other corporations will have a much harder time raising capital by selling bonds. If American investors get stiffed by the government, how will potential foreign investors view this shabby treatment? Could they be next?

Let the Micromanaging Begin

While many people might say GM did not really have a business model for the past 25 years, can we expect the new one at Government Motors to be any better? After all, there are now 535 members on the de facto board of directors, each making political rather

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Party (Percent of Debt Owed): $107 billion (100%)	Bankruptcy Settlement:
1. U.S. Government $50.5 billion (47.2%)	61.8% of the common stock $8.8 billion in preferred stock
2. UAW's VEBA Trust Fund $20 billion (19%)	17.5% of the common stock $6.5 billion in preferred stock $2.5 billion note $10 billion directly to trust fund
3. Canadian Government $9.5 billion (9%)	11.7% of the common stock $1.7 billion in preferred stock
4. Bondholders $27 billion (25%)	10.0% of the common stock

than economic decisions. The recent bizarre treatment of the GM dealerships illustrates this point.

GM planned to eliminate about 2,400 of its 6,000 dealerships. What should have been a pure business decision has, unfortunately, gotten wrapped up in politics. Those dealers slated for closing have appealed to Congress for help. According to CNN, "The push by the dealers to reverse the cuts has garnered strong bipartisan support, especially from powerful Democratic Leaders Financial Service Committee Chairman Barney Frank and House Majority Leader Steny Hoyer." So far, the Automobile Dealer Economic Rights Restoration Act of 2009 has 250 House and 26 Senate cosponsors. The bill is designed to "re-open profitable dealerships and restore basic fairness."

The elite class has known all along that the real problem at GM was that it built too many SUVs and light trucks and not enough of the fuel-efficient cars that consumers really want. It now appears that at the new Government Motors environmental considerations will trump business considerations. Congress and the various regulatory agencies, such as the EPA, have been micromanaging the auto industry in the "green" direction for decades with their ineffective and deadly Corporate Average Fuel Economy (CAFE) program. The new CAFE standard calls for all cars and trucks to get 35.5 mpg by 2016. No GM vehicle currently meets the new standard.

Given that the government is now a majority shareholder in the auto industry, expect even more green micromanaging. It has already started. Energy Secretary Steven Chu, who is on the task force, recently said that the Obama administration is thinking about requiring all new cars to run on E-85 gas (85 percent ethanol). This mandate will cost the auto industry $1 billion a year. It is worth noting that E-85 gas is available at less than 2 percent of the gas stations nationwide.

In deciding where to build the new green compact cars that will save the company, the new GM considered the "community impact" and "carbon footprint" of the production facility. Ironically, it ultimately settled on the Orion, Michigan, plant where Reagan had disavowed central planning a quarter century earlier.

President Obama has said that his decision to take a majority stake in GM was unavoidable and that it would be temporary. This remains to be seen. However, we have been down this road before. In 1971, the federal government became the majority shareholder in Amtrak. This too was unavoidable and was to be temporary. Amtrak has been a ward of the state ever since; costing the taxpayer $2.6 billion a year to operate.

I fear that the new slogan in America will be, "Is this any way to run an *auto company*?" FEE

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The "I Hate the Poor" Act of 2009

BY CHRISTOPHER WESTLEY

So I was shaving the other day, and the man on the morning talk radio show was on a roll. Cash for Clunkers was being temporarily shut down, or so declared the PR flack in the Department of Waste that administers the program, and Talk Show Guy thought this taught great lessons. "This was a good program! I really liked it!" the self-described conservative drawled over and over. "But if the guv-mint can't manage a good program worth $1 billion, why does anyone think it can manage a single-payer health care system they say will cost $1 trillion?"

A clunker, according to the U.S. government.
Falk W. Müller

Cash for Clunkers, of course, was the popular term for the Car Allowance Rebate System, which funded down payments of up to $4,500 for new cars if older-model cars were traded in and destroyed. The program was temporarily discontinued and then officially ended after barely a month of operation. Around 700,000 vehicles were purchased as a result of the program, according to government and industry statistics. It wound up costing $3 billion.

Talk Show Guy was right, I thought, careful not to cut myself. When you offer $3 billion in free money to people, why was anyone shocked that they went for it? And if you offer free health care to a supposedly narrow segment of the population that cannot now access it, why do economic planners create budget projections that assume healthcare demand will remain static?

But that wasn't what caused me to move the razor from my face. That had to do with all of the talk about Cash for Clunkers being such a good program. It clearly wasn't, or at least it shouldn't have appeared so to anyone who remembers the basics of college economics. From this perspective, there is so much wrong that it's hard to know where to start.

Cleaning Up Inventories, Not the Environment

First, let's dispense with the notion that this bill had anything to do with improving the environment. Getting people into cars that get better mileage often leads them to drive more, negating any benefit from the switch. What's more, scrapping hundreds of thousands of "clunkers" en masse while encouraging production of new cars to replace them isn't exactly an environmental blessing either.

The real purpose of the program was to help car dealers sell off the excess supply of 2009 vehicles that consumers weren't buying at the prices dealers preferred to charge. Giving people free money to put toward a down payment was a way for Congress to pay back a powerful lobby that produced an unsustainable

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level of output during the Fed-fueled boom. It's reminiscent of those New Deal programs—like the Agricultural Adjustment Act—that also tried to thwart falling prices by destroying perfectly good and usable products that otherwise would have lowered prices. In the 1930s people rioted when the government forced farmers to pour perfectly good milk down sewer drains. No one's rioting today because now the government is more richly compensating those who own the property being destroyed. (For a fascinating, contemporary account of the Agricultural Adjustment Act and other New Deal programs, see journalist John T. Flynn's *The Roosevelt Myth*. For a more recent account, see Amity Shlaes's *The Forgotten Man: A New History of the Great Depression*.)

Bootleggers and Baptists, Dealers and Greens

What we have is a situation described by Clemson University economist Bruce Yandle's "Bootleggers and Baptists" theory for the growth of government. According to Yandle, government often grows because two otherwise opposite groups are able to join forces to pass legislation that neither would have been able to get passed individually. His example applied to groups that supported alcohol prohibition: The bootleggers benefited from the outlawing of their "legitimate" competition, and religious groups opposed liquor sales as a matter of morals. When both groups joined forces, legislation became far more likely to pass.

This program sticks it to those members of society least able to manage in hard times.

Applying Yandle's theory to the clunker program, the bootleggers were car dealers who faced low consumer demand and sales revenues at current prices, while the Baptists were environmentalists who believed that older-model cars insult mother earth. The prospect of an old-car trade-in program unites both groups.

Cash for Clunkers certainly had its share of winners and losers. Car dealers who experienced summer profits surely won, as did those individuals who otherwise would have gone without cars. And let's not forget the banks and finance companies that now have loan assets on their books. You can be sure the members of Congress who voted for this bill will remind dealers of their generosity in directing other people's money their way in this old-fashioned shell game.

And it is a shell game, because the losers here are the poor and the lower middle class—the very groups in the most precarious economic shape 18-plus months into the Great Recession. They suffer in two ways. First, as primary consumers in the used-car market, they will see supply shrivel. Many cars that qualified for Cash for Clunkers still had long lives ahead of them.

The poor will also pay in the form of higher prices resulting from the inflation that will be required to finance the program. The government is broke, with tax revenues falling while spending soars at levels even higher than those associated with the profligate Bush administration. In terms of cost, Cash for Clunkers is at least twice as expensive as its New Deal inspiration, the Agriculture Adjustment Act. This program will be paid for, at some time, with monetary inflation furnished by our not-so-independent central bank, and we will pay for it in the form of higher prices. This is why inflation is a tax, and a regressive one at that.

Indeed, when I first read about Cash for Clunkers, I thought it should have been named the "I Hate the Poor" Act of 2009 because—you can be sure—this program sticks it to those members of society least able to manage in hard times. In the end they will find maintaining economic autonomy all the harder, making it more likely they will become dependent on government in the future. The cynic in me wonders if this might be the actual intent.

Nonetheless, Talk Show Guy thought this was a good program. He liked it! I bet he got a good deal on a new car, too. Hope he enjoys his ride. FEE

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Science Fiction and Economic Fiction

BY DONALD J. BOUDREAUX

Thomas Macaulay Boudreaux, age 12 and my only child, is a *huge* fan of *Star Trek*. Actually, even an italicized "huge" doesn't quite capture the extent of Thomas's fascination with, and knowledge of, the franchise. From Captain Pike through Mr. Spock to Ensign Sato, Thomas knows and loves anything and everything *Star Trek*.

So in August I took Thomas to Las Vegas for the year's biggest *Star Trek* convention. Attending that three-day event caused me to reflect more seriously than I have yet done on the late Gene Roddenberry's master creation.

First and foremost, *Star Trek* is indeed entertaining. Led by Thomas, I myself have become something of a Trekkie. (*Star Trek: The Next Generation* is my favorite series, although I like each of the five series quite a lot.) As Brent Spiner (the actor who plays Data) noted at the convention, *Star Trek* is, above all, an action-adventure show—and there's action and adventure galore.

But here are some other observations.

I easily forgive a sci-fi series such as *Star Trek* for being sketchy about how today's known truths of the laws of the natural world are harnessed by future humans to make extended space exploration possible. For example, it's not clear just how artificial gravity is created and maintained so uniformly on Starfleet vessels, and it's certainly a stretch to assume that the Milky Way galaxy is filled with lots of "M-class planets"—planets with an atmosphere, temperature range, and gravitational force nearly identical to Earth's.

To quibble about such artistic liberties, however, would be to miss the larger, more interesting picture. But I cannot forgive the many *economic* errors made in the series. These errors don't merely stretch known economic truths; they dispense with them altogether.

One example occurs in the 1984 *Star Trek* movie *The Voyage Home*. In that film, Captain Kirk and his crew travel back in time to 1984 San Francisco to capture a humpback whale. These whales had gone extinct by the twenty-third century and the good Starfleet captain and his crew have reason to try to restore the species.

While in the twentieth century a zoologist informs Mr. Spock that the hunting of whales is threatening the species's existence. On hearing this comment, Mr. Spock volunteers that "to hunt a species to extinction is illogical."

Not at all. When property rights are poorly defined and enforced—either because technology is inadequate to the task or because government interferes—valuable resources often are overused. Most famously, poorly defined property rights often lead to a "tragedy of the commons." Because the open oceans are not owned by anyone, and because a whale doesn't become anyone's property until it is captured, no one has any incentives to preserve whale stocks so that whales can sustainably reproduce. They are "overfished." This result is quite logical. Mr. Spock should learn some economics.

> Mr. Spock should learn some economics.

Another example of economic ignorance in *Star Trek* occurs in a third-season episode of *Enterprise*. It is, again, an error committed by a logic-worshipping Vulcan who travels back in time with the ship's captain. In that episode, Subcommander T'Pol and Captain Jonathan Archer visit early twenty-first-century America. As they drive through a California town, T'Pol asks the captain if humans of that era were aware that they

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were running out of oil. She goes on to observe that oil did in fact finally run out in 2161.

T'Pol's claim is ludicrous. First, there is no evidence that we are running out of oil. As MIT economist Morris Adelman wrote in 2004 (the year after that episode was filmed), known reserves of oil recently reached an all-time high. Second, if and when oil does become much more scarce than it is today, its price will rise—and will keep rising as oil becomes more scarce. This higher price will both cause consumers to economize on oil and oil-based products, and prompt entrepreneurs to redouble their efforts to find suitable substitutes for oil.

At some point, the cost of extracting additional oil buried deep within the earth's crust will exceed the value of doing so—not only because this cost will be very high but also because alternative sources of energy will be more attractive.

If businesspeople in a free market were like the "ultra-capitalist" Ferengi, they'd go broke.
Mary Harrsch

Merchants of Menace

Perhaps most annoying of all, though, is the portrayal of the Ferengi. These are a merchant class of humanoid aliens, appearing most prominently in the series *Deep Space Nine*. Wikipedia describes the Ferengi as "ultra-capitalist"—and it's pretty clear that the *Star Trek* writers would see that description as accurate.

But accurate it certainly is not. The Ferengi are obsessed with profit, and so *Star Trek* writers portray them as crass, often-cheating, mean-spirited, oily characters. Those few Ferengi portrayed sympathetically are ones, such as Rom, who mysteriously don't share the Ferengi obsession with pecuniary gain. (*Star Trek* fans: I realize that the portrayal of Quark is more nuanced, but it doesn't come close to negating my interpretation.)

In addition to having the Ferengi costume look clownish and filling Ferengi mouths with sharp, ugly teeth, *Star Trek* writers have composed a set of strictures that the Ferengi allegedly follow. Called "The Ferengi Rules of Acquisition," these 286 pieces of allegedly capitalist wisdom are mostly absurd. Consider:

Rule #1: "Once you have their money . . . never give it back." Any businessperson who refused to return money to a dissatisfied customer would not be in business for long. Competitors more accommodating to consumers would outcompete such ignoramuses.

Rule #2: "Never allow family to stand in the way of opportunity" and Rule #21: "Never place friendship above profit." No doubt a few capitalists are sociopathic in this way—just as, no doubt, so too are a few politicians. But how many businesspeople do you know who would wittingly sacrifice their families' and their friends' best interests even for the smallest economic gain?

Rule #27: "There's nothing more dangerous than an honest businessman." Really now. Anyone who knows anything about capitalist reality knows that dishonest businesspeople eventually are caught—not so much by the law but rather by consumers who prefer to deal with honest businesspeople. Dishonest business dealings are a sure recipe for business failure.

Rule #52: "Never ask when you can take." This rule is one for thieves, not merchants and producers. It is indeed a rule consistently followed by politicians but not by businesspeople.

Nevertheless, my complaints to the contrary, now that I am finished composing this column, I will boldly go into the family room to watch an episode of *Star Trek* with Thomas! FEE

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The Mystique of Hedge Funds

BY WARREN C. GIBSON

Hedge funds are controversial these days. Though it's unlikely that the average citizen or the average congressman could say just what hedge funds do, many are certain they must be reined in by additional regulation because they can—and do—cause widespread damage to our financial system. Almost everyone takes it for granted that regulation of some sort is the solution, ignoring the possibility that at least some of the problems are actually caused by regulation.

What is a hedge fund? The name implies hedging, a strategy that reduces risk. If you bet on several horses in a race, you are hedging your bets—spreading your risk. You can buy gold to hedge against inflation. You can sell interest-rate futures to hedge the risk that rising interest rates would pose to your bond portfolio.

The first hedge fund was created in 1949 by Alfred Jones. He believed he could pick stocks that would outperform and those that would underperform the overall market. But Jones didn't know where the overall market was going, so he would buy his expected outperformers and sell short the expected underperformers. He thereby insulated his portfolio from general market moves, which would affect about half his holding positively and half negatively.

Most present-day hedge funds don't do much hedging, but the name persists. Instead, they engage in a bewildering variety of trading methods, including buying on margin (using borrowed funds) and selling short (selling borrowed assets so as to profit from a price drop). They trade stocks, bonds, options, currencies, commodity futures, and sophisticated derivatives thereof. Some try to anticipate global political or economic events, while others seek opportunities in specific industries or companies.

Most present-day hedge funds don't do much hedging, but the name persists.

Hedge funds are like mutual funds in some ways. A mutual fund sells shares to investors and uses the proceeds to buy stocks or bonds (usually). A fund's income and realized capital gains are distributed to shareholders, while unrealized capital gains are reflected in higher mutual fund share prices. Like mutual funds, hedge funds are typically open-ended, meaning they can sell shares to new investors from time to time or repurchase them from existing shareholders.

There the resemblance ends. Anyone can buy mutual fund shares, but hedge fund shares are generally available only to "qualified investors," defined by an annual income of at least $200,000 and financial assets of $1,000,000. Withdrawals of capital are only permitted at limited times. Shares cannot be offered or advertised to the general public, which can be an advantage because it may make investors feel that they are gaining entrée into an exclusive club.

Hedge fund managers are more lightly regulated than mutual fund managers. They are allowed to charge performance-based fees, for example, which is forbidden to mutual fund managers. Though management fees vary widely, hedge fund managers typically retain 20 percent of any gains. This gives them some "skin in the game," which presumably motivates them to do

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well for their investors. However, they do not share in fund losses. Hedge funds typically charge short-term redemption fees to discourage short-term trading and maintain a stable asset base.

Perhaps the biggest difference between the two fund classes is that hedge funds are free to take very large risks, while mutual fund managers are constrained against "excessive" risk-taking.

Stupidity in the Hedge Fund Business

Long Term Capital Management (LTCM) was a hedge fund that collapsed in spectacular fashion in 1998. The immediate cause was the Russian bond default, but, more fundamentally, LTCM relied too much on sophisticated computer models and extreme use of leverage, meaning almost all its capital was borrowed. When the Russian government defaulted on its bonds, it set off a chain of events that LTCM's models had indicated was essentially impossible. These events produced huge losses that took the fund to the brink of default, threatening big losses for its lenders, including some of the largest and most influential New York banks. So the Federal Reserve Bank of New York came to the rescue, arranging a $3.6 billion bailout, a sum that seems quaint by today's bailout standards. The same "systemic risk" argument that we hear today went around then: A default on those loans, it was said, would be an intolerable shock to the financial system. "Too big to fail" was the reason; "too well-connected" was perhaps more accurate.

Even though the fund eventually recovered without losses to the bailout guarantors, the LTCM failure represents a missed—and golden—opportunity. Had the fund been allowed to fail, and had the big banks taken their losses, it would have struck some well-deserved fear into the hearts of fund managers, investors, and especially bankers. Our current financial crisis might have been less severe as a result. LTCM was very secretive about its strategies, and the bankers who loaned money to the fund likely knew next to nothing about what LTCM was doing with it until it was too late. They were awestruck by the reputations of the LTCM partners, two of whom had shared the 1997 Nobel Prize in economics. Had LTCM been allowed to go under, its example would have tempered risky behavior by others. If uninsured depositors at these banks had also lost money, they too would have gotten a valuable wakeup call. Instead, a brick was added to the house that came to be called the "Greenspan put." It said: Go ahead and take risks. If you win you collect the profits. If you lose, we'll cover you.

> Hedge fund shares are generally available only to "qualified investors," making investors feel that they are gaining entrée into an exclusive club.

Hedge Funds: Bane or Boon?

Is it wise to take high risks as hedge funds do? For most people, no. For those whose resources are large enough that they can afford to lose some capital and who enjoy the thrill of the chase, perhaps yes. We all have different temperaments and different circumstances. A free society respects these differences and does not stop its members from taking risks nor shield them from the consequences.

As long as there is no fraud, hedge funds, like other market participants, produce social benefits. They provide market liquidity, the lubrication that makes markets work well. Successful funds help move capital to where it is most needed and help move prices in anticipation of future events. Unsuccessful funds go out of business sooner or later, and investors in failed funds learn to be more careful about whom they select to handle their money.

But regulation brings unintended consequences, many of them harmful to the people they are supposed to protect. Absent regulation, it is unlikely there would be a separate category called hedge funds, distinct from mutual funds.

Unfortunately, in January the President's Economic Recovery Advisory Board, headed by Paul Volcker, called for registration of hedge funds and public disclosure of their holdings. Fund managers will likely resist disclosure, which can damage their mystique and invite free riders. The board report addressed not only hedge

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funds but also any other "systemically significant" financial institution of any type, and the criteria by which systemic significance is to be judged were left vague. To their credit the board members recognized that "a modest system of registration and regulation can create a false impression of lower investment risk."

The Hedge Fund Transparency Act (Senate Bill 344) was introduced shortly after the report was released. It has been in committee ever since. It would cover private equity funds and venture capital funds along with hedge funds.

Market participants will very likely find ways to get around any new regulation or to co-opt it, as they generally do.

Regulation: Rationale and Reality

Business regulation almost invariably starts with wide popular support. Most people assume big business must be restrained lest it run roughshod over the little guy. But often, as in the Progressive Era a century ago, it is big business that actually promotes regulation, expecting it to put smaller competitors or would-be competitors at a disadvantage. Often regulators start out conscientiously dedicated to their jobs, but over time familiarity can transform them into advocates for those they regulate. Hedge fund regulation is no different.

Why are people of modest means forbidden to buy hedge fund shares? The presumption is that they lack the knowledge and sophistication necessary for intelligent risk-taking. Common folk must be protected from themselves, lest they get in over their heads. After all, we can't have people gambling their rent money. (Unless, of course, they're gambling on state lottery tickets.) The regulation that was supposed to protect small investors actually protects large investors by locking out their smaller competition.

The prohibition on advertising by hedge funds (or other "private placements") blocks potentially useful information. It is harder for managers and investors to find each other when important information is, in effect, censored. Middlemen, such as financial planners or trust officers, are left to fill the gap, which they do relatively inefficiently.

The rule forbidding mutual fund managers to charge performance-based fees again hurts the little guy by denying access to performance-motivated managers. It also drives up the fees that hedge fund managers can charge by shielding them from mutual fund competition in this respect. Thus both hedge fund investors and mutual fund investors come out on the short end of this regulation.

Why are people of modest means forbidden to buy hedge fund shares? The presumption is that they lack the knowledge and sophistication necessary for intelligent risk-taking.

Regulators sometimes fail to catch the bad guys—see the Bernard Madoff case—but they sometimes destroy good guys as well. Art Samberg has enjoyed a long career as a successful stock-picker. By 2001 he and a colleague had built Pequot Capital Management into the largest hedge fund in the world, riding the technology wave up and later shorting it on the way down. In 2001 the Securities and Exchange Commission began investigating the firm for insider trading, but no charges were ever filed and Samberg strenuously denies any wrong-doing. Guilty or not, by last May the bad publicity had taken such a toll that Samberg announced he would shortly liquidate his fund—sell all its holdings and return cash to the shareholders. (Whether insider trading is something that should really be forbidden is a subject for another time.)

Regulation has many other drawbacks. But a badly neglected one is that government-imposed minimum standards tend to become *maximum* standards. People take less care to understand what they're getting into with a regulated investment because they assume that regulators have diligently vetted the offerings. All firms getting a pass from the regulators tend to be treated alike. That's when trouble begins. FEE

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Old, Bold Futility

BY WILLIAM R. ALLEN AND WILLIAM DICKNEIDER

In economic analysis and policy formulation, profundity is not to be confused with complexity. And simple logic is not the same as simplicity. Reliance in thought and communication on shortcut slogans and mottos yields not solution but fiasco.

With employment slumping, many would have us believe in a simplistic "bold economic recovery program." With vast public-works projects to build and rebuild so-called infrastructure—highways, bridges, sewers—we could allegedly create jobs.

We may have neglected our infrastructure. Perhaps we would be more productive if we invested more in maintaining and expanding such basic capital. But the condition of our infrastructure commonly is not the central issue. The more immediate question is whether government spending would increase total employment.

> The expansion of public-works jobs is likely to cause jobs to contract elsewhere, with little net change in aggregate employment.

Public-works programs clearly would directly create specific jobs. But expansion of public-works jobs is likely to cause jobs to contract elsewhere, with little net change in aggregate employment. Other employment will contract because federal expenditures on public-service jobs must somehow be financed. If the federal government is to increase spending for public works, then it must reduce other government expenditures or raise taxes or deficit-spend.

If government reduces spending for other programs, such as national defense, then fewer workers will produce guns. Or if government reduces transfer payments to selected individuals, then fewer workers will produce the butter that beneficiaries would have demanded. In either case, decreases in federal expenditures in one area to finance increases in public works will not increase total employment.

Instead of curtailing other spending in order to increase expenditures on public works, government might raise taxes and thereby curtail private consumption and investment. With private spending down and government spending up, private jobs are traded for public jobs, and total employment is not increased.

If, alternatively, government finances the expansion of public works by enlarging its already enormously swollen deficit, then it will either have to borrow existing money or create new money to pay its increased bills. If it borrowed existing money from the community, government would compete more intensely with businesses and households for financial resources. More money would then go to government and less to private firms and individuals. Government spending of borrowed funds would displace private spending of private funds. Again, some jobs are traded for others.

Finally, what if government financed its increased deficit spending by creating new money? In this instance, spending need not fall in other areas, so new

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public-works jobs would not reduce other employment—initially. But down the line, increased money creation, if continued fast enough long enough, will raise prices. And higher prices—a pernicious form of taxation—would threaten future productivity and employment. We would then obtain a bit more force-fed employment today at the expense of less employment and more misery tomorrow.

Inflation is not a function solely of rapidly increasing money stock, to be sure. The rate at which money is spent—the velocity of monetary circulation—also affects aggregate community expenditure. Velocity has trended downward over the last decade and fell abruptly in late 2008, which partially offset the rising amount of money. But in a period of substantial inflation, we will see both the amount of money and its rate of spending rise. When expenditure goes up faster than the production of goods—and it is vastly easier to create money than to create goods—we have inflation.

No matter how government finances it, greater spending for public works is not likely to increase the total number of jobs significantly. Economic thinking leads to this conclusion, but does history support it?

More Spending, No More Jobs

The economy is not a laboratory in which experimentation readily yields conclusive evidence. But we can look at how past government spending in general has related to total employment.

Data for the last 80 years indicate that big increases in federal spending have not typically been associated with large increases in employment. Indeed, the loose relationship that existed over those decades is quite the opposite. Faster growth of employment has been associated with slower growth of federal spending, and slower growth (or reduction) of employment was more likely when federal spending grew faster.

From 1929–33 government outlays increased by almost half—over 48 percent—while unemployment surged more than eightfold.

In the New Deal period of 1933–39, government spending rose at an annual rate of over 12 percent, doubling in just six years, while employment increased at only 2.5 percent. The unemployment rate was nearly 25 percent in 1933, and was still more than 17 percent in 1939. The then secretary of the Treasury acknowledged in 1939 the basic failure of the spending program.

No one has found a significant, consistently positive relationship between government spending and total employment in the United States or any other country.

In 1962–66 and in 1975–81, employment expanded at an annual average of 2.2 percent in each period, but government spending rose 6 percent in the earlier years and at more than double that rate in the later period.

From 2001 to the present, government outlays have risen at an annual rate of nearly 7 percent, while employment has expanded at a measly 0.8 percent. In the past year and a half, employment actually fell.

No one has found a significant, consistently positive relationship between government spending and total employment in the United States or any other country. The reason is simple. The money spent by government has to come from somewhere. Certainly, there are things that can be done to promote a vigorous economy. But it should be apparent that government cannot simply and surely spend us to rapidly expanding employment. FEE

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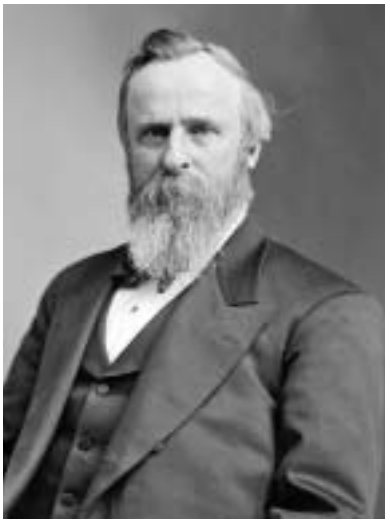
Rutherford B. Hayes and the Financing of American Prosperity

BY BURTON FOLSOM, JR.

Rutherford B. Hayes, America's nineteenth president (1877–1881), is generally dismissed as a minor, even below-average president. Matthew Josephson, the journalist-chronicler of the late 1800s, insisted that Hayes had "no capacity for . . . large-minded leadership." Other historians have written him off as just another cipher among a string of forgettable chief executives of the Gilded Age.

But the truth is that Hayes was a strong and principled leader of firm character, who, during a critical time in history, shored up the country's finances. His contributions to restoring American credit are worth noting today.



Rutherford B. Hayes
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Hayes was a small-town Ohio lawyer until his Civil War exploits earned him a promotion to brigadier general and won him a congressional seat after the war. After one term in Congress, Hayes was elected three times as governor of Ohio. In 1876 he won the Republican nomination for president, and during the campaign that followed he defeated Governor Samuel Tilden of New York in a controversial election. Tilden won the popular vote, but Hayes won the electoral vote after a special commission awarded him the disputed states of Florida, South Carolina, and Louisiana.

Severe Inflation

Once in the White House, Hayes withdrew northern troops from the South and thus ended Reconstruction. But the enormous financial debts from the Civil War still lingered. That war had been so costly that the Union could not secure the cash (that is, specie) to fight it. Congress and President Lincoln covered expenses by issuing over $400 million in greenbacks, which would not be redeemable in gold until some future date. The flood of greenbacks caused inflation and chaos—merchants wanted specie, not paper that someday might be redeemed.

Many Americans, especially debtors who liked the idea of repaying loans in inflated currency, welcomed the greenbacks and wanted more to be printed. The problem with that, apart from serious inflation, was that foreigners were refusing to buy American debt, which raised the interest costs on the almost $2 billion that the Union borrowed to fight the war.

In 1875 Congress had promised to redeem the greenbacks for gold in four years and Hayes ran his campaign on a pledge to fulfill that promise. "Low rates of interest on the vast indebtedness we must carry for many years," Hayes said, "is the important end to be kept in view."

As president, therefore, Hayes prepared to retire the greenbacks. He had budget surpluses every year in office, and he used these extra funds to help build up a gold reserve to pay off the greenbacks. So effective was Hayes at this task that when the official government redemption date (January 2, 1879) came around, few people stepped forward to get gold for their greenbacks. Confidence in U.S. credit was such that most people traded greenbacks at face value with confidence that gold would be in the Treasury if they ever wanted it.

Having solved the greenback problem, Hayes also faced a crisis with silver. From the beginning of U.S.

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history, gold and silver coins (and bullion) had circulated to pay debts, to conduct trade, and to transact business. Silver of course is more plentiful than gold, and the ratio had been 15 or 16 ounces of silver to 1 ounce of gold. The U.S. Treasury in fact minted coins and traded the metals at 16 to 1 during much of the 1800s. But that all stopped after the Civil War.

The problem was that active mining in the American West was yielding much more silver than gold. Also, the demand for silver was down because the rest of the world was beating a path to a monometallic gold standard. By the end of the 1800s, with silver prices down, it took about 32 ounces to buy one ounce of gold. The silver miners believed this devaluation of their metal was unfair. Those who favored inflation were happy to agree: If the government would stabilize the ratio at 16 to 1, debtors could repay in inflated silver dollars instead of gold. Flooding the market with silver (fixed at 16 to 1) would have the same effect as running greenbacks off the printing press.

Hayes was appalled at the persistent efforts of inflationists to tamper with the currency. "Expediency and justice both demand honest coinage," Hayes insisted. Sound currency and sound character were one and the same to Hayes. "A currency worth less than it purports to be worth," Hayes observed, "will in the end defraud not only creditors, but all who are engaged in legitimate business, and none more surely than those who are dependent on their daily labor for their daily bread."

Free Silver

The inflationists lobbied hard with their politicians for what was called "free silver," which was short for the free and unlimited coinage at the fixed ratio. They couldn't muster the votes, but they did support the Bland-Allison Act in 1878.

Under that bill Congress would be obligated to buy at least $2 million (and up to $4 million) worth of silver and mint it into special dollars of almost one ounce. Such "dollars" in 1878 contained only about 90–92 cents worth of silver, and Hayes was dismayed that Congress would even consider tampering with U.S. coins that way. He promised to veto any "measure which stains our credit." When Congress passed the act anyway, Hayes vetoed it. Congress, however, overrode Hayes with a two-thirds vote, and the Bland-Allison bill became law.

The presence of these new silver dollars bothered Hayes, but American credit remained strong throughout the world. The greenback problem was under control and the government continued to retire the Civil War debt through annual budget surpluses. In 1880, for example, federal revenue was $333.5 million, which was $65.9 million—almost 20 percent—more than expenses. The biggest item in the federal budget was $95.8 million for interest on the debt. With diligence, Hayes had renegotiated much of this debt from 6 to 5 and sometimes 4 percent.

In an effort to slash future expenses, Hayes began efforts to make government bureaucrats work more honestly and efficiently. In the New York Customs House, for example, some officials were extorting payments from importers and other officials were drawing salaries but doing almost no work. Since President Grant, Hayes's predecessor, had suffered greatly from the shenanigans of dishonest government officials, Hayes tried extra hard to reform the civil service and make sure government graft was kept to a minimum.

> Sound currency and sound character were one and the same to Hayes.

Finally, Hayes showed balance in his administration. When, during a massive railroad strike in 1877, a state governor asked him to send in federal troops to preserve order, Hayes obliged. But he would not use federal troops to break the strike.

Hayes was a constitutional president. He believed in an executive strong enough to veto bad legislation, but he did not want to expand executive powers beyond what the Constitution specified. Congress was where laws needed to originate and where most political debate needed to take place.

Politics to Hayes was not a career. After serving one term as president, he happily stepped down and returned to private life. FEE

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The Great Writ Then and Now

BY WENDY McELROY

Habeas corpus is a rarely invoked legal writ, or document, widely considered to be the cornerstone of individual liberty. Also known as The Great Writ, habeas corpus (*ad subjiciendum*) is Latin for "you may have the body" (subject to examination). The writ is a civil action with the force of a court order, which requires a custodian, usually the government, to produce a detainee.

The purpose is not to determine the detainee's innocence or guilt but to evaluate whether the detention itself is lawful; that is, does it satisfy the standard set by the law of the land? If the imprisonment is judged to be valid, the person must submit to a trial or whatever procedure is prescribed. If the imprisonment is invalid, the person must be released. In short, the government cannot imprison you without just cause and due process.

Although habeas corpus is not commonly raised as a legal challenge, it has been mentioned with some frequency in recent issues—from the prison at Guantanamo Bay, Cuba, to the detention of illegal immigrants to the FLDS ranch raid by Texas child-welfare services. Critics of these government actions claim that they erode the principle of habeas corpus. The word "unconstitutional" is often used because the Constitution is the legal standard that an imprisonment must ultimately satisfy in the United States.

In the course of discussing such events, theoretical questions about The Great Writ arise. Is it a natural right or a privilege granted by government? If habeas corpus is a privilege, does government have an obligation to extend it to all people regardless of citizenship? If it is extended only to citizens, are there circumstances through which a citizen can lose the "privilege"? Purely practical questions arise as well. For example, do constitutional constraints bind only the federal government and not the states?

Apart from rights theory and practical considerations, another aspect of habeas corpus deserves attention because it explains why the writ is invoked so often in debate though so rarely in court: namely, its psychological impact. Habeas corpus is a powerful concept that evokes strong emotions. This is largely because it is viewed as a litmus test for whether a government is a dictatorship. In his article "Habeas Corpus: The Lynchpin of Freedom," Jacob Hornberger of the Future of Freedom Foundation explains how habeas corpus is the enforcement arm of all other rights. Using First Amendment guarantees of free speech as an example, he writes,

> Habeas corpus is viewed as a litmus test for whether a government is a dictatorship.

> [H]ow is that provision enforced? Editors, critics, and protestors would be languishing in some military detention center. . . .What good would it do to point out that people have the constitutional right to speak their mind, criticize government policy, and petition the government for redress of grievances?

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> The president and the military would be in charge. . . . The doors to the cells would remain locked. The prisoners would be unconditionally subject to whatever treatment their jailers wished to impose. The prisoners would be prohibited from going to court to complain or to seek redress. That's where habeas corpus . . . comes in.

Michael Zander, emeritus professor of law at the London School of Economics, expands on the psychological importance of the Great Writ: "Habeas corpus has a mythical status. . . . In reality it is no longer of great practical significance as there are today very few habeas corpus applications, but it still represents the fundamental principle that unlawful detention can be challenged by immediate access to a judge—even by telephone in the middle of the night."

Thus, despite debate and periodic suspension by government, habeas corpus has endured within law because the idea of an authority having the power to imprison someone without cause is abhorrent to general sensibilities.

Sir Edward Coke made habeas corpus legally and politically prominent.
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Historical Background

According to the eighteenth-century jurist William Blackstone, the first instance of the term "habeas corpus" appeared in 1305. But the concept is generally assumed to have been part of the common-law tradition at the time of Magna Carta. Signed in 1215 by King John, Article 39 states: "No freeman shall be taken, or imprisoned, or disseized, or outlawed, or exiled, or in any way harmed—nor will we go upon or send upon him—save by the lawful judgment of his peers or by the law." (The wording evolved over time.)

Magna Carta assumed political and legal prominence in the early seventeenth century when it was reinterpreted and used to advantage by the lawyer and parliamentarian Sir Edward Coke. Coke was a passionate advocate of common law over supreme monarchy; he famously proclaimed in Parliament, "Magna Carta is such a fellow that he will have no sovereign." In 1628 he helped to draft the Petition of Right, which became a foundational document of the English Constitution. The Petition detailed the specific liberties of freemen, which legally constrained the king. For example, martial law could not be declared during a time of peace, and prisoners could use habeas corpus to challenge the legitimacy of their imprisonment.

The reinterpretation of Magna Carta had a profound impact on the American colonies, the charters for which were drafted during this period. Indeed, Coke may well have been one of the authors of the Virginia Company charter. These charters guaranteed that colonists would enjoy "all the rights and immunities of free and natural subjects." Moreover, American revolutionaries like Thomas Jefferson and James Madison were intimately familiar with Coke's four-volume *Institutes of the Laws of England*. When drafting their own documents to ensure liberty, the Founding Fathers drew heavily on his ideas. For example, the Third Amendment of the Bill of Rights derives from the Petition of Right's ban on billeting troops.

The Founding Fathers also drew on the Habeas Corpus Act of 1679, which passed Parliament during the reign of King Charles II and strengthened that right against the power of the king. When it crossed the Atlantic to America, however, habeas corpus underwent a subtle but significant change. In England it was a weapon against monarchy that originated in the "rights" of nobles and only later grew to embrace the average person. In America it began as a core protection that every individual enjoyed against any governing authority.

The only specific reference in the Constitution occurs in the Suspension Clause (Article I, Section 9—"Limits on Congress," Clause 2): "The privilege of the writ of habeas corpus shall not be suspended, unless when in cases of rebellion or invasion the public safety may require it."

Although the reference is brief, it is highly significant that this particular protection of civil liberty is in the body of the Constitution while similar protections,

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such as the right to trial by jury, occur only in the appended Bill of Rights. There, the closest reference to habeas corpus occurs in the Sixth Amendment, which states a defendant must "be informed of the nature and cause of the accusation." Thus the explicit inclusion of The Great Writ in the body of the Constitution suggests its importance for the Founding Fathers.

Nevertheless, the constitutional guarantee was a federal one and did not extend to those in state custody.

Habeas Corpus in the U.S.

The most famous habeas corpus case in pre–Civil War America was that of the slave Dred Scott, who attempted to sue for his freedom. An earlier and similar case in England would have given Scott reason for hope. In 1772 an African-American slave named James Somersett ran away from his master while they were both in England. He was recaptured but sympathizers obtained a writ of habeas corpus that required his captors to produce Somersett in court where he sued for and won his freedom. This case set the legal precedent that slavery was unlawful within England proper.

Lincoln suspended habeas corpus in 1862 to end resistance to the draft; Congress legitimized it in 1863.
Graphic courtesy sonofthesouth.net.

Almost a century later Dred Scott petitioned the U.S. federal court for a writ of habeas corpus; it was granted and later upheld by a court of appeals. Nevertheless, in 1857, in one of the most controversial cases in American history, the U.S. Supreme Court ruled against Scott seven to two. The court found that no slave or descendant of a slave could be an American citizen and so Scott was not a "person" within the purview of the Constitution. He did not possess the right of habeas corpus.

The writ continued to be intimately connected with slavery. During the Civil War, President Lincoln suspended habeas corpus in both 1861 and 1862; it was not restored until 1866.

The first suspension came early in the Civil War through an edict in 1861, when an estimated 20,000 Confederate sympathizers in Baltimore tried to block the movement of Union troops to Washington, D.C.

John Merryman, an officer in the Maryland cavalry and a secessionist, was among the thousands arrested. He petitioned for a writ of habeas corpus, which was granted by Chief Justice Roger B. Taney—the same Justice who presided over the Dred Scott case. Taney ordered the military to bring Merryman before the court; the military refused, citing Lincoln's edict of suspension, Taney ruled that Lincoln's suspension was unconstitutional because such a measure required an act of Congress. Lincoln basically ignored the ruling and continued to expand the territory throughout which habeas corpus was suspended.

The second suspension occurred when Congress instituted America's first national military draft in July 1862, which incited widespread rebellion. On March 3, 1863, Congress passed the Habeas Corpus Act, legitimizing Lincoln's former suspensions and approving any others he might make for the duration of the war.

Lincoln's earlier suspension had been so broad as to allow local authorities to arbitrarily arrest anyone they personally considered to be disloyal or whose politics they simply disliked. Some of those arrested had done nothing more than criticize Lincoln. Union General Henry Halleck famously arrested a Missouri man merely for saying, "[I] wouldn't wipe my ass with the stars and stripes." Estimates of those arrested range widely, but overall 10,000 to 15,000 were probably imprisoned and denied a prompt trial. The Habeas Corpus Act, however, limited the time a person could be held without trial and so removed one of the most contentious aspects of the imprisonments.

It was not until 1866, with the court case *ex parte Milligan*, that the impropriety of the imprisonments

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themselves was put on trial. But the issue was legalistic and not based on civil liberty. The Supreme Court ruled that applying military tribunals to civilians in areas where civilian courts still operated was unconstitutional.

The post–Civil War period also resolved the issue of whether the right to petition for habeas corpus was purely federal or extended to the states. A Reconstruction act established that those held in state prisons and jails had the right to petition for a habeas review in federal court; this meant the writ applied to everyone imprisoned in America. Since then, the majority of habeas petitions reviewed in federal court have come from state prisoners through state courts for state crimes. This makes habeas corpus a rich area in terms of the relationship between federal and state courts and federal and state law.

Camp X-Ray hosted George W. Bush's attempt to circumvent, then circumscribe, habeas corpus.
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Contemporary Implications

History seems arcane but it assumes a living, breathing status when courts rule based on precedent. This was apparent in what is arguably the most significant development in habeas corpus within the last decade: *Boumediene v. Bush* (2008). The case began with a writ of habeas corpus submitted to the U.S. Supreme Court on behalf of the foreign citizen Lakhdar Boumediene, who was detained in the American military camp at Guantanamo Bay.

In November 2001 President Bush had asserted the authority of military commissions to try prisoners taken in Afghanistan or Iraq as "enemy combatants." In early 2002 he established Camp X-Ray in Guantanamo and claimed that since the camp is not on American soil, the prisoners had no rights under the Constitution or the American legal system. Representatives of almost 200 detainees filed habeas corpus submissions over the next three years.

In 2004 the Supreme Court heard the first of these cases—*Rasul v. Bush*. The court's landmark ruling found that the American legal system had authority to decide whether foreign "enemy combatants" were being wrongfully detained. In response, the Defense Department established Combatant Status Review Tribunals—nonpublic hearings that reviewed whether detainees met the criteria necessary to satisfy the designation "enemy combatant." These tribunals were widely criticized as not fulfilling the requirements of *Rasul*. For example, the Court had affirmed a detainee's right to be assisted by counsel, yet the tribunals did not permit this.

To quell growing criticism over the Guantanamo detainees, Bush signed the U.S. Military Commissions Act (MCA) in October 2006. Congress stated its intention "to authorize trial by military commission for violations of the law of war, and for other purposes." The MCA explicitly abolished habeas corpus rights for noncitizens.

Boumediene—which consolidated with the earlier petition *Al Odah v. United States* (2002)—tested the constitutionality of the MCA, specifically appealing to the clause in the Constitution stating that the right to challenge detention "shall not be suspended" except in cases of "rebellion or invasion." In June 2008 the Supreme Court's 5–4 decision effectively struck down the MCA as an unconstitutional denial of habeas corpus; the ruling also asserted the jurisdiction of federal courts over such petitions from Guantanamo detainees who had been tried under the MCA.

Theoretical Questions

Along with history, theoretical debates have driven the evolution of habeas corpus.

The key theoretical debate concerns whether habeas corpus is an inalienable natural right that preceded the State or a privilege granted by government. An inalienable right is one that cannot be transferred or taken away.

The Declaration of Independence, of course, embraced natural rights as the basis of liberty when it stated, "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their

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Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness."

If any right can be called "inalienable," habeas corpus must be included on that list. As noted earlier, the right not to be imprisoned unjustly is the foundation on which all others rest. Indeed, in the absence of habeas corpus, the rights of due process—including trial by jury and facing your accuser—become meaningless.

The body of the Constitution contradicts both the Declaration of Independence and the Bill of Rights on habeas corpus, however, because the Suspension Clause makes it alienable and a privilege granted by government. Under certain circumstances defined by government, it can suspend habeas corpus, putting all other rights at the pleasure of the authorities.

Despite the contradictions and political maneuvering, the United States enshrined habeas corpus as a foundational right for every human being on American soil.

No external threat or internal problem can dismantle the individual freedoms on which America was created. Only government and the American public can accomplish that. FEE

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Stealth Expansion of Government Power

BY MURRAY WEIDENBAUM

The government of the United States spent the year debating major new undertakings, ranging from health care to climate change to energy development to tax reform. Yet a far more fundamental shift, in the form of a rapid and pervasive expansion of government power over the private sector of the economy, has been going on in stealth. Shifting economic power from individual decision-makers to the national government characterizes virtually every policy proposal being debated in Congress.

Take tax policy. A 131-page document issued by the Treasury (www.tinyurl.com/okwrer) goes way beyond recommending the extension of some of the expiring Bush administration tax cuts. For example, the fine print contains more than a dozen ways of discouraging American firms from doing business and investing overseas. Supposedly minor technical changes also would have a severe impact.

For example, eliminating LIFO (last in-first out) inventory accounting would raise business taxes over $60 billion in one decade. The Treasury also wants to revive four corporate environmental taxes that were eliminated in 1969. There's no relation between the tax burden these four taxes would impose on a company and the pollution that company generates. This bears an uneasy resemblance to Willie Sutton, who robbed banks because that was where the money was.

Inevitably a variety of technical tax provisions will increase the paperwork burden on business. The penalties for failing to file information returns (such as Form 1099) promptly and accurately, for example, will rise in a very complicated, three-tiered fashion.

On the expenditure side, the typical stimulus project increases the power of government in private business decision-making. The bailout of the automobile industry is really an inefficient method of financing union pension and health plans. The stockholders got zapped and the bondholders poorly treated. The taxpayers are left holding the bag, especially considering the restrictions on importing the really fuel-efficient cars General Motors produces overseas. Apparently, the new General Motors factory for building compact cars was chosen on the basis of "carbon footprint" and "community impact."

Shifting economic power from individual decision-makers to the national government characterizes virtually every policy proposal being debated in Congress.

It is hard to keep a straight face when analyzing the Cash for Clunkers program. For example, owners of the biggest old "clunkers" got a $3,500 credit for trading in an old vehicle for a new one with an improvement of just one mile per gallon. Surely, it would have saved energy if the Treasury had just mailed the $3,500 checks directly to Detroit!

Of course, the Obama administration is making some reductions in federal spending. It is reportedly

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imposing a 9 percent reduction in the budget for the division in the Labor Department that polices fraud and other illegalities on the part of labor unions. As noted below, a simultaneous *expansion* of business-oriented antitrust enforcement is taking place.

The Business of America is Government

Turning to regulation, one of Ralph Nader's biggest disappointments during his heyday as a "consumer advocate" was the failure of his proposal for a new Consumer Protection Agency. He should be a bit happier now: The administration's financial regulatory plan creates a powerful new Consumer Financial Protection Agency (CFPA).

This new free-wheeling agency would take authority now divided between the Securities and Exchange Commission (SEC) and the Federal Reserve System. In a change guaranteed to cause confusion, the CFPA would share authority with the Federal Trade Commission. The new regulatory agency would also have a mandate to give consumers more economic education. Educators find that especially scary.

Moreover, the agency will have its own money pot, independent of the normal congressional appropriations process. It will be financed directly by fees assessed on "entities and transactions" across the financial sector.

The Treasury's financial plan contains many other expansions of government power over business. The Federal Reserve System would have new authority to oversee any large financial entity whose failure the Fed thinks could generate "systemic risk." The Treasury would head a new Financial Services Oversight Council to "resolve" the inevitable jurisdictional disputes among federal agencies. A new Office of National Insurance is to be established in the Treasury to monitor "all aspects of the insurance industry," a sector of the economy traditionally under the province of state governments.

The SEC will require the registration of all advisers to hedge funds and other private pools of capital with assets over a given threshold. It also will have the power to inspect the books of the advisers and to ensure compliance by their clients. In addition, the power of the SEC will be expanded by legislative proposals to give it a more active role in guiding the compensation committees of all public companies.

Further, the Federal Deposit Insurance Corporation will have new authority to take over and shut down financial institutions (not just banks) whose failure is deemed to pose "systemic risk."

Viewed in their totality, these technical financial changes would represent a historic expansion of government. Sadly, there is little comfort in the Treasury's warning in its 88 pages of detailed proposals: "More can and should be done in the future." Comparisons with the New Deal of the 1930s are too timid. Shades of Alexander Hamilton!

Viewed in their totality, these technical financial changes would represent a historic expansion of government.

Business-Climate Change

The complicated climate change bill that recently passed the House of Representatives would dramatically expand government power over the economy. Again, the fine print deserves far more attention than it has received. For example, buried in the 1,201 pages of detail is a provision authorizing the Department of Transportation to require automotive manufacturers to produce vehicles that can run on methanol (wood alcohol), a fuel not widely available.

Other provisions, as expected, have little to do with the subject of global warming. For example, contractors on some energy projects must pay employees at least the locally "prevailing wage." This well-known code means, in practice, paying higher union wage scales, thus letting unions set wages even for non-union firms.

Many federal departments are trying to climb aboard the economic stimulus bandwagon. The Department of Justice wants to help out by showing that antitrust should be a "frontline issue" in the response to the problems facing the economy. Apparently, business is not getting sued often enough. Incredibly, one

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new assistant attorney general views antitrust enforcers as "key members of the government's economic recovery team."

When we step back and try to add up all the tax, spending, and regulatory actions and proposals of the new Obama administration, the result is clear: a cumulative squeeze on private decision-making and a more slowly growing economy in the years ahead.

In the process, private businesses will be discouraged by a host of government policies from making major new investments, especially long-term investments with payoffs far in the future. The likelihood of higher taxes and greater inflation resulting from the huge budget deficits that are likely to arise in the next several decades, abetted by lax monetary policies, are the key negative factors. The American public is likely to have a long wait until the national unemployment rate gets back down to the 7.6 percent that was reported when President Obama took office in January 2009.

> The Obama administration's tax, spending, and regulatory actions add up to a cumulative squeeze on private decision-making.

One fundamental point deserves to be stressed. For the next several years, in the inevitable tension in public policymaking between economic prosperity and income redistribution, the American people can expect income equalization to get the government's priority over improvements in people's living standards. The average American, at best, will receive a more equal slice of an income pie that will be far smaller than the public expects. FEE

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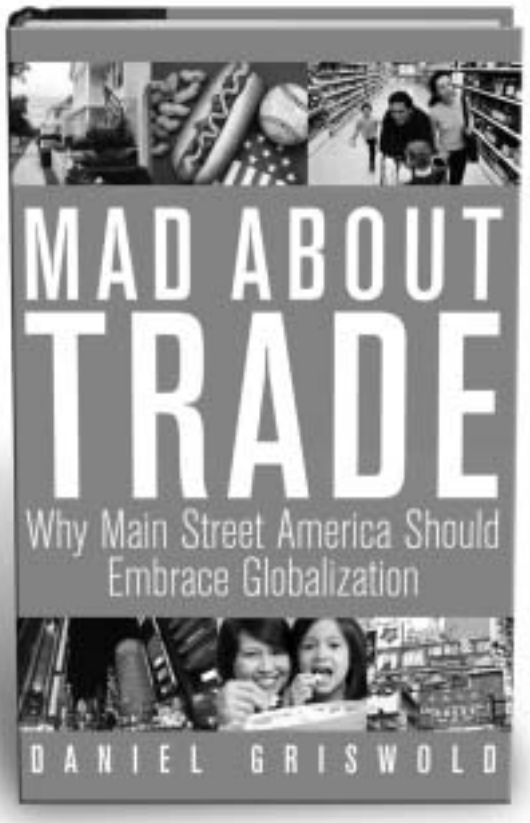

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Art Needs No State Subsidies

BY BRUCE EDWARD WALKER

It's feeding time again, and artists and cultural groups are lining up at the trough. The bailout package approved by Congress in February threw another $50 million at the arts. For the better part of the past year, music impresario Quincy Jones beseeched Barack Obama to add a secretary of arts to his cabinet. In March the President established a new staff position to oversee arts and culture in the Office of Public Liaison and Intergovernmental Affairs. Kareem Dale, named special assistant to the president for disability policy in February, was elevated to the new post. This—or any—government interference in the arts is at the very least short-sighted.

A subsidy! A subsidy! My kingdom for—wait a second . . .
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For the nearly 250,000 people who signed Jones's online petition, the arts are touted as critical to our national identity and even a source of spiritual sustenance. Use of the term "art," however, is rife with conflict—raising more questions than answers. For the purposes of this essay, let's agree that art, as a result of its examination of the myriad states of the human condition, can be a repository of both empirical and received knowledge and lore, an outlet for specialized creativity, and a cultural bonding agent. But to speak in the high-flown language of art's ability to convey a national identity is to make teleological claims that can be neither substantiated nor dispelled. It sounds cool, sure, but so does visualizing world peace and (for some) levitating the Pentagon. And the claims for spirituality are best left to the theologians. *My* heart leaps when I behold a rainbow in the sky, for example, but I'm afraid those refracted light rays may leave others colder than Miss Havisham on her wedding night or a Jack London character attempting to strike his last remaining match.

Different Art, Different Audiences

Defining art and its many purposes and intended audiences is tricky. Classicists, for example, probably would say that art can be appreciated only from a distance of 100 years or more, assuring historical validation from critics, academics, and a refined general public. For this audience, Shakespeare, Michelangelo, and Beethoven are art's *sine qua non*. Only recently—within the past 50 years or so—have they been convinced that James Joyce, Virgil Thompson, and Joan Miró belong to the canon.

Bruce Edward Walker (walker@mackinac.org) is communications manager for the Mackinac Center for Public Policy's Property Rights Network. He has authored CliffsNotes *on Ken Kesey's* One Flew Over the Cuckoo's Nest, *Edith Wharton's* The House of Mirth, *Willa Cather's* Death Comes for the Archbishop, *and Lewis Carroll's* Alice's Adventures in Wonderland *in addition to writing more than a hundred reference book, magazine, and newspaper articles on arts funding, novelists, poets, philosophers, filmmakers, and musicians.*

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Others position art at the vanguard of culture—always one step ahead of the rest of us with self-referential and highly individualized creations that eventually percolate to the fringes of the mainstream and exert a huge influence on subsequent generations.

The Cherry Pickers

In between the snobs and the avant garde are the cherry pickers, the multitude who have no trouble bouncing from Mozart and Mahler to Berry Gordy and the Beatles. "It doesn't have to be old to be classic, it just has to be good" was the classic-rock radio tagline a few years back. Informed cherry pickers recognize that cultural uplift—however pristine or watered-down—can be found at the local cinema, on television programs, and even sandwiched in the spaces between those programs. The 1968 eight-million-selling record "I'd Like to Teach the World to Sing (In Perfect Harmony)," for instance, began as a group effort between gurus at advertising agency McCann Erickson and their client Coca-Cola. It became a hit single.

Cherry pickers can immerse themselves in many different art forms, increasingly blurring the distinctions between high art and low art. High art often borrows from popular (or low) art as evidenced by the work of Roy Lichtenstein and Andy Warhol.

Conversely, popular art borrows freely from high art. The artist Hieronymus Bosch, for example, may be well-known to some, while others know his work only from the use of his "Garden of Earthly Delights" as cover art for an album by folk-rock group Pearls Before Swine or the song "OK, Hieronymus" by British-born rocker Graham Parker. Shakespeare references abound on such television programs as *Star Trek*. Even Barry Manilow cribbed from Chopin.

In short, let's acknowledge that art is important for most of us and that the enjoyment thereof is a matter of degrees. One man's Proust is another man's Pelecanos. One woman's Bach is another's Bachman Turner Overdrive. Cherry pickers are dilettantes, but that need not be used in a pejorative sense, since they can—and often do—create a wider cultural perspective through aesthetic cross-pollination across genres and the blending of high and popular art.

Let's acknowledge that art is important for most of us and that the enjoyment thereof is a matter of degrees.

Government-Funded Art

Because art is many things to many different people, how can government-funded agencies hope to anticipate the aesthetics of a wide-ranging, diverse population? The question is moot, of course, but the larger questions remain: Can government money create a nation of renaissance men and women equally conversant in the realms of visual, written, and performance art—and are such ends desirable in the first place? Have government subsidies sparked the creation of any prominent new art, reintroduced the best of historically validated art to new generations with lasting impact, acculturated immigrants to the best of Western thought, ideals, and talent, or led to anything remotely resembling the equivalent of Italy's fifteenth-century Rinascimento? Whither art without my tax dollars?

In his 2008 book *Money for Art*, David A. Smith presents a detailed history of U.S. government funding for the arts, beginning in 1817 when Congress commissioned four paintings by John Trumball. Nine years later, Trumball unveiled four historical paintings depicting events of the U.S. Revolution. According to Smith, Trumball was paid $32,000, a sum that rankled several politicians. One disgruntled senator reportedly believed the paintings unworthy of 32 cents, while Smith quotes one congressman's observation that "if the Fine Arts cannot thrive in this country without government jobs . . . let them fail."

By the end of the nineteenth century art flourished largely due to the largess of successful businessmen. The Gilded Age captured in the literature of Mark Twain and Edith Wharton was highly fruitful for the nation's art, witnessing the establishment of the Metropolitan Museum of Art (1870, New York), the Boston Museum of Fine Arts and the Philadelphia Museum of Art (both 1876), the Chicago Academy of Fine Arts

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(1879), and the Corcoran (1869, Washington). All opened their doors without government money, as did a plethora of other museums, private collections, and art schools.

By the end of the century, art school alumni were producing a surfeit of fine art, which coincidentally is the title of a Jacques Barzun essay warning that government subsidies for art could produce such a large quantity of high-quality art that the nation would be unable to discern between what is merely good, what is very good, and what will stand the test of time.

When Theodore Roosevelt became president, he helped infect the American population with his passion for art. But Roosevelt's views on art were somewhat provincial. He famously disparaged Modernist art in a review of the 1913 New York Armory Show and openly sneered at American painters who traveled abroad for their subject matter. Before leaving office in 1910 he ordered the establishment of the Commission of Fine Arts (CFA) to encourage arts and culture in Washington. Proving the wisdom of Ronald Reagan's adage: "The nearest thing to eternal life we will ever see on this earth is a government program," the CFA received $10,426,000 in 2008 federal money. For 2009 the CFA requested only $2,234,000—covering only department salaries.

The New Deal of the 1930s found innovative ways to fund art by offering commissions to artists seeking work. In 1933 some out-of-work artists formed the Unemployed Artists Group, which eventually became knows as the Artists' Union (AU). The AU unsuccessfully sought the establishment of a cabinet-level Department of Fine Arts.

Although the New Deal programs for artists expired when the nation emerged from its financial travails, they left an indelible imprint on the nation's cultural mavens. As Smith so aptly states: "The New Deal's most important legacy to artists . . . was a mild sense of entitlement among professional artists and the beginnings of strong organization and collective action to pressure the government to respond to artists' needs."

Although the New Deal programs for artists expired when the nation emerged from its financial travails, they left an indelible imprint on the nation's cultural mavens.

While FDR's administration was busy inventing new sleight-of-hand parlor tricks to divert tax dollars to individual artists, others took a more honorable route. Automotive scion Edsel Ford and his wife Eleanor, for example, became the Detroit Institute of Art's (DIA) greatest benefactors by commissioning art from the likes of Diego Rivera and purchasing with their combined fortune works for the DIA's permanent collection. They even took it upon themselves to cover the museum's payroll during the Great Depression.

Fiscal restraint for government arts funding fell like dominoes in the 1950s and 1960s. Eisenhower approved the National Cultural Center (completed with government funds and renamed the Kennedy Center during the Johnson administration) in 1958; Kennedy ordered Congress to establish the National Council on the Arts, which during the LBJ administration became the overseer of the National Endowment for the Arts (NEA). Reports of the first meeting of the Council mention that work progressed only in the morning, because members Harper Lee and John Steinbeck needed to sleep off their lunch-hour tippling—auspicious beginnings for an institutionalized steward of American tax dollars with a budget that reached $176 million in 1992 and receded to $145 million in 2009 plus the $50 million stimulus supplement.

Artists In Their Own Words and Works

Most artists believe that without government subsidies, quality art would disappear. "The voice of the artists has been relegated to entertainment or a marketable commodity or to a nuisance, but neither the political class nor the mainstream media are paying attention to what the artist is saying and that to me is worrisome," Mexico-born performance artist and National Public Radio commentator Guillermo Gómez-Peña told me in a 2008 interview. "We can see since the mid-'90s

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art has been defunded systematically throughout the world not just in the U.S. but also in European societies that were leaders in that funding in places like Germany, the U.K., France or even Eastern European countries that took very good care of their artists. Even Mexico, for centuries paid very careful attention to its artists."

Although Gómez-Peña, a very articulate, intelligent, and accomplished artist, adopts a pessimistic view of art without government support, he attaches to it an almost religious urgency: "In a sense, this systematic attack on the arts by the political class, the corporations, and the mainstream media has resulted in the spiritual impoverishment of society."

Likewise, Dolores Wilber, a Chicago filmmaker I interviewed in 2006, believes public funding of private art is a net positive for the American people: "Art is a reflection of the society and it's about creativity and being alive and has provided a lot of positive things in the social fabric with every society whether it's democratic or a totalitarian government. . . . I think it's a great thing about our country that in general we do support art making."

Serious art and serious artists can survive—and have survived—without subsidy. In fact many of the greatest poets of the past 100 years pursued careers that greatly enhanced the literature they produced: William Carlos Williams was a doctor; Wallace Stephens was an insurance broker; former NEA head Dana Gioia worked as an advertising/marketing manager for General Foods; T. S. Eliot was a banker and editor; and Gary Snyder worked as a lumberjack and fire lookout. Many current artists are also tenured faculty at esteemed universities that pay them healthy sums to court their respective muses.

Serious art and serious artists can survive—and have survived—without subsidy.

Gómez-Peña and Wilber are earnest, but one also senses a degree of hubris in their overstatements of art's transformational and spiritual powers—as well as their belief that it's the public's responsibility to pay for it. After all, we can accept the importance of art privately without the concomitant expectation of having to pay for someone else's transcendent experience. In fact, it wasn't government largess that created and distributed HBO's *The Wire* and *The Sopranos*, arguably the pinnacle of the last ten years of visual storytelling; Coppola's *Godfather* epic; the Beatles' *Sergeant Pepper*; or even initially transferred millions of consumer dollars to Robert Mapplethorpe and his estate—it was talent, drive, unfettered creativity, and the public's willingness to purchase these works on their own terms rather than the whims, opinions, and highly subjective tastes of government bureaucrats. FEE

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Competition

BY JOHN STOSSEL

"Choice, competition, reducing costs—those are the things that I want to see accomplished in this health reform bill," President Obama told talk-show host Michael Smerconish back in August.

Choice and competition would be good. They would indeed reduce costs. If only the President meant it. Or understood it.

In a free market, a business that is complacent about costs learns that its prices are too high when it sees lower-cost competitors winning over its customers. The market—actually, the consumer—holds businesses accountable and keeps them honest. No "public option" is needed.

So the hope for reducing medical costs indeed lies in competition and choice. Today competition is squelched by government regulation and privilege.

But Obama's so-called reforms would not create real competition and choice. They would prohibit them.

Obama's so-called reforms would not create real competition and choice. They would prohibit them.

Competition Produces Knowledge

Competition is not a bunch of companies offering the same products and services in the same way. That sterile notion of competition assumes we already know all that there is to know.

But consumers often don't know what they want until it's offered, and their preferences and requirements change. Businesses don't know exactly what consumers want or the most efficient way to produce it until they are in the thick of the competitive hustle and bustle.

Nobel laureate F. A. Hayek taught that competition is a "discovery procedure." In other words, the "data" of supply and demand emerge *only* through the market process. We need open-ended competition not merely to see which rival is better, but to learn things we didn't know before and aren't likely to learn any other way.

"Competition is valuable *only* because, and so far as, its results are unpredictable and on the whole different from those which anyone has, or could have, deliberately aimed at," Hayek wrote.

Well-meaning politicians have created untold misery by assuming they and their experts know enough already.

The healthcare bills are perfect examples. If competition is a discovery process, the congressional bills would impose the opposite of competition. They would forbid real choice.

If You Liked the Election, You'll Love the Public Option

In place of the variety of products that competition would generate, we would be forced to "choose" among virtually identical insurance plans. Government would define these plans down to the last detail. Every one would have at least the same "basic" coverage, including physical exams, maternity benefits, well-baby care, alcoholism treatment, and mental-health services. Consumers could not buy a cheap, high-deductible catastrophic policy. Every insurance company would have to use an identical government-designed pricing structure. Prices would be the same for the sick and the healthy.

In this respect, it wouldn't matter whether Congress created a "public option"—that is, a government insurance plan. In either case, bureaucrats would dictate virtually every aspect of the health-insurance business.

John Stossel is the hosts of Stossel *on Fox Business and the author of* Myths, Lies, and Downright Stupidity: Get Out the Shovel—Why Everything You Know is Wrong. *Copyright 2009 by JFS Productions, Inc. Distributed by Creators Syndicate, Inc.*

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What Obama says in favor of a public option tells us how little he understands competition. The public option's virtue, he told Smerconish, is that "there wouldn't be a profit motive involved." But as contributing editor Steven Horwitz, a professor of economics at St. Lawrence University, wrote in *The Freeman*, profit is not just a motive (www.tinyurl.com/m4nd2j). Profit (along with loss) is what enables competition to perform its discovery role:

"Suppose for a moment that we try to take the profit motive out of health care by going to a system in which government pays for and/or directly provides the services. . . . For many critics of the profit motive, the problem is solved because public-spirited politicians and bureaucrats have replaced profit-seeking firms.

"Well, not so fast. By what method exactly will the officials know how to allocate resources? By what method will they know how much of what kind of health care people want? And more important, by what method will they know how to produce that health care without wasting resources? . . . In markets with good institutions, profit-seeking producers can get answers to these questions by observing prices and their own profits and losses in order to determine which uses of resources are more or less valuable to consumers. . . . [P]rofits and prices signal the efficiency (or lack thereof) of resource use and allow producers to learn from those signals."

> Profit is the key to competition. Anyone who claims to favor competition but looks down at profit has no idea what he is talking about.

Profit is the *key* to competition. Anyone who claims to favor competition but looks down at profit has no idea what he is talking about. FEE

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Book Reviews

How Much Money Does an Economy Need? Solving the Central Economic Puzzle of Money, Prices, and Jobs

by Hunter Lewis
Axios Press • 2008 • 185 pages • $17.00

Reviewed by Lawrence H. White

In *How Much Money Does an Economy Need?* Hunter Lewis addresses some of the most fundamental questions of monetary policy in a question-and-answer format. For a subject often clouded by technicalities, the language is refreshingly plain. Sometimes *too* plain, perhaps, to satisfy an academic economist. But academic economists aren't the intended audience. The book can be read profitably by interested laymen, including bright high-school students.

Lewis poses excellent questions and gives fairly good answers. His questions include: Should prices in general be stable, fall, or rise? and Should the stock of money grow continuously, never, or sometimes? He conducts a dialog with himself over these questions, first defending a "yes" answer, then a "no," and then offering additional replies and counter-replies. His sympathies lie with what he describes as "the Austrian, laissez-faire, or free-market point of view," but he endeavors to represent the alternative Keynesian view fairly.

Lewis is to be applauded for presenting the case for letting prices fall in a growing economy. Unfortunately he appears to have overlooked some of the strongest previous presentations of that case. We must distinguish between a harmless deflation, where technological progress or other sources of improved productivity lower costs and thereby gently draw prices down, and a harmful deflation, where shrinkage in the stock of money or its velocity brings unsold inventories and thereby painfully forces prices down. Lewis recognizes a distinction between gentle and painful, but oddly claims that, in the view of its defenders, "deflation is always good," even when "quite painful." Claiming that deflation is *always good* is absurd because there is no benefit from deliberately creating a deflation by shrinking the money stock. Auric Goldfinger's plan, in the James Bond story, to nuke the gold in Fort Knox, thereby raising the purchasing power of his own gold, was the plan of a villain not a hero. Just as a central-bank-engineered monetary expansion disrupts the economy and causes misallocation of resources—something Lewis recognizes—so too does a central-bank-engineered monetary contraction.

To his credit Lewis identifies the error of monetary expansionism: "If you have four apples and a dollar, the dollar may help you price and trade the apples. But adding another dollar will not increase wealth; it will simply raise the price of the apples." Unfortunately, he fails to identify the corollary error of deliberate contractionism.

In the second half of the book, Lewis discusses what he calls "the problem of banks," meaning the question of fractional-reserve banking. Here Lewis—following and citing Murray Rothbard's *The Case Against the Fed*—offers the view that fractional-reserve banking is prone to runs, "inherently destabilizing" for the broader economy, and should be outlawed as fraudulent. Uncharacteristically, he neglects to consider the other side: the historical studies indicating that free banking with fractional reserves is not run-prone but robust, the theoretical arguments for the efficiency and economically stabilizing character of free banking, and the jurisprudential arguments for the legitimacy of voluntary fractional-reserve arrangements based on freedom of contract.

Defenders of fractional-reserve free banking (the present reviewer included) would reject the claim that, like a central bank, "a fractional reserve bank can also 'print' new money" arbitrarily. Any bank in a competitive system issuing gold-redeemable notes and deposits is tightly constrained, unlike a monopoly central bank. Contra Lewis, the money supply in a fractional-reserve free banking system is neither "over elastic" nor "generally expanding." Lewis might have consulted Mises's *The Theory of Money and Credit* and *Human Action* more closely on these points.

Lewis does a good job of sketching the Austrian theory of the boom-bust cycle resulting from a central

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bank's cheap-credit policy. And he sagely notes that when a central banker promises to inflate the economy and bail out financially troubled firms, "then it becomes more rational to speculate, to take excessive risk, and not at all rational to save, to take precautions, to be prudent. In this respect . . . so-called stabilization is actually de-stabilizing."

The book contains three appendices, respectively concerning the Federal Reserve System and its operations, the gold standard and other international monetary arrangements and institutions, and nonmonetary cycle theories. The appendix on the Fed unfortunately gives an incorrect account of how the money multiplier and open-market operations determine the money stock.

The academic economist-reviewer cannot resist noticing some other errors. For example, no sensible view holds that a period of inflation typically or automatically leads to a period of deflation in a fiat money economy. A determined central bank can issue enough money to keep the price level rising continuously, as almost all have since the fiat era began in earnest in 1971.

Despite its shortcomings, this book is an interesting and useful introduction to the important question posed in its title. FEE

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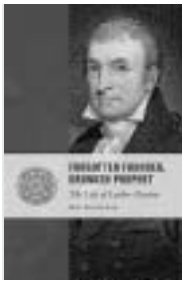
Forgotten Founder, Drunken Prophet: The Life of Luther Martin

by Bill Kauffman

Intercollegiate Studies Institute • 2008 • 225 pages • $25.00

Reviewed by Joseph R. Stromberg



Antifederalists get no respect. Historian Cecilia Kenyon called them "men of little faith." Other historians (even Charles Beard) pegged them as rural debtors. In this brief but engaged life of Luther Martin, though, Bill Kauffman enters a plea for "the people who lost"—an unAmerican enterprise he shares with William Appleman Williams.

Martin, likely the most interesting Anti of all, is hardly known today, but Kauffman finds much of value while dealing unflinchingly with Martin's public and private life.

With ancestors in America since 1623, Martin was born in 1744 or 1748 in New Jersey. He excelled at Princeton and studied law at Williamsburg, where he befriended Patrick Henry. Thence he went to Maryland, serving as a revolutionary propagandist and as attorney general of Maryland from 1778 on. He drank excessively and was often in debt.

Sent as a delegate to the select and secretive Philadelphia Convention, Martin was shocked by the impending coup underway. He discerned three factions: consolidationists like Alexander Hamilton, big-state men like James Madison, and a "truly federal" element. Together, the first two parties set the tone, pursuing a "counterrevolutionary" nationalist agenda to subordinate the states. Working with John Lansing, Jr. and Robert Yates (both of upstate New York) in an "ad hoc small state/states' rights caucus," Martin tried to limit the damage caused by the emerging system that Lansing called "a triple-headed monster"—a mythic theme, if ever there was one.

Before leaving the convention in disgust, these critics made interesting points too numerous to treat here. Oddly, Martin was the father of the so-called "supremacy clause," the point of which was to subject the new Leviathan's acts to the law. Federal Delphic oracles were not yet in the plan, and Martin wanted treaties and federal statutes subject to interpretation by the *state* courts. Having left the conclave early, Martin reported what he had seen to the Maryland legislature. For Kauffman, Martin's *The Genuine Information* is "*the* Anti-Federalist Paper." Martin continued the fight in the press, advocating a bill of rights, limits on the standing army, and reliance on militia.

But the Federalists managed to "control the debate" and won the day. Martin remained Maryland's attorney general, never held federal office, and argued 40 cases before the U.S. Supreme Court. In court performances, he knew the law and the cases but was seldom fully

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sober. Hating the elusive Thomas Jefferson, Martin became "a states' rights Federalist" but never apologized for his opposition to the Constitution.

Martin defended Federalist Judge Samuel Chase against impeachment and made Chase a martyr. It was not, Kauffman suggests, his finest hour. He also defended Aaron Burr against Jefferson's charges of treason. Kauffman comments, "[Supreme Court Justice John] Marshall rule[d] for once as a strict constructionist" on whether Burr had actually *levied war*. In *McCulloch v. Maryland* (1819) Martin argued Maryland's right to tax the Bank of the U.S., while Marshall wrote a "landmark" decision to the contrary—that is, a tedious essay in Federalist ideology.

Along the way Kauffman refutes some well-entrenched myths. Yes, Martin was long-winded, but his "diffuse" speeches were "coherent" and "struck a nerve." Kauffman challenges the claim that Madison's *Journal of the Constitutional Convention* is a spotless primary source, while Antifederalist eyewitnesses are wholly untrustworthy.

In Kauffman's judgment, there was "no pressing external threat" in 1787 requiring central aggrandizement. He ridicules the Federalists' "airy reassurances" and their easy assumption that Washington would be the measure of future presidents. Their sense of political *scale* was no better. Superior sorts far outshining local "demagogues" would, they said, invariably serve at the federal level. But of course those "immigrant" nationalists Hamilton and James Wilson (a "deracinated Scot") and Madison, "the farsighted abstractionist," were in a hurry. It is no surprise that Kauffman remarks upon the universal values and globalism of certain framers and that he turns some counterfactual horror stories on their heads. Quite insightfully, Kauffman takes the apparent American "nationalists" of the Old Dominion as Virginian imperialists out to dominate the federation.

For Kauffman, the Antis were "plain people" who saw the political scale "getting too big." They wished to conserve the local and familiar. Today they seem rather prophetic. After ratification, Martin observed, "powers once bestowed upon a government, should they be found ever so dangerous or destructive to freedom, cannot be resumed or wrested from government but by another revolution." In our present state we may wonder if the Antis' New Jersey Plan and plural executive were such awful alternatives. We may let Martin himself have the last word. Speaking of the Great Convention, Martin wrote in March 1788: "Happy, thrice happy, would it have been for my country, if the whole of the time had been devoted to sleep, or been a blank in our lives, rather than employed in forging its chains." FEE

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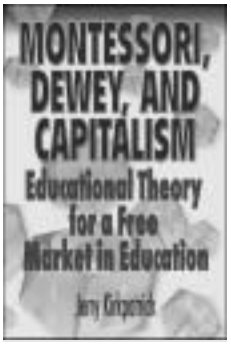
Montessori, Dewey, and Capitalism: Educational Theory for a Free Market in Education

by Jerry Kirkpatrick

TLJ Books • 2008 • 212 pages • $42.95 hardcover; $18.95 paperback; $8.95 Kindle and Mobipocket

Reviewed by Terry Stoops



For years, school-choice proponents have assessed and reassessed the possibilities of expanding government support for vouchers. Jerry Kirkpatrick's *Montessori, Dewey, and Capitalism: Educational Theory for a Free Market in Education* is a refreshing alternative to those tired discussions of political coalitions, legislative machinations, and disparate school-choice programs. Indeed, Kirkpatrick's book is one of the first to consider the methodological and instructional foundations of an educational free market, and the author does so in an original and engaging way.

Kirkpatrick argues that the goal of education should be to cultivate self-esteem and independence and reject coercion and rationalism, thereby freeing the young mind and encouraging children "to be actively curious and practically self-assured." To achieve these goals, he constructs a theory based on "concentrated attention," a psychological concept central to the educational theories of Italian educator and philosopher Maria Montessori. Kirkpatrick defines concentrated attention as the "heightened awareness of one object out of

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the many that exist in our field of awareness." According to Kirkpatrick, most educational approaches seek to either coerce children or neglect them altogether, but concentrated attention focuses on educational methods that nurture the child. He meticulously details the proper methods of employing concentrated attention and also outlines the content of education—the knowledge, values, and skills—needed to thrive in a free society.

Where did the idea of concentrated attention come from? Kirkpatrick finds its first clear expression among the child-centered educational theories of Enlightenment thinkers like John Amos Comenius, John Locke, and Jean-Jacques Rousseau. In the nineteenth century Johann Pestalozzi, Johann Herbart, and Friedrich Froebel further developed the psychological and philosophical foundations of child-centered education. In the early twentieth century John Dewey and Maria Montessori provided the modern theoretical foundations of the concept of concentrated attention. One may have wished, as I did, that Kirkpatrick had augmented this chapter by discussing the slew of dubious child-centered educational practices that followed Dewey and Montessori. Even so, Kirkpatrick's history of child-centered versus teacher-centered theories of education is highly instructive.

While Montessori's ideas provide a solid foundation to Kirkpatrick's theory, Dewey's educational theories appear to undermine it. Dewey was a collectivist who sought to use state-sponsored coercion to properly "socialize" children. In isolation, some of Dewey's ideas may resemble Montessori's concept of concentrated attention, but Dewey wasn't interested in cultivating independent young minds. He was interested in using public schools to cultivate dependency on the State.

In defense of his use of Dewey's ideas, Kirkpatrick argues against conflating Dewey's political and educational philosophies. On one hand, Kirkpatrick acknowledges that Dewey and his Progressive colleagues sought government control over schooling. On the other, he suggests that Progressives wanted to free students from coercive educational environments by urging public schools to adopt student-centered instructional approaches. Kirkpatrick calls this a "contradiction," but many critics maintain that Dewey's political and educational philosophies were compatible. For example, in *Anti-intellectualism in American Life*, historian Richard Hofstadter noted that Dewey assumed "a kind of pre-established harmony between the needs and interest of the child and 'the society we should like to realize.'" Kirkpatrick's effort at separating Dewey's political and educational philosophy is not entirely persuasive.

It is also difficult to agree with Kirkpatrick's contention that there is an underlying compatibility between the educational theories of Dewey and Montessori. Dewey identified serious differences between his educational theories and Montessori's. In *Schools of Tomorrow*, for example, he argued that Montessori adhered to "older" psychological theories, which asserted that "people have ready-made faculties which can be trained and developed for general purposes." Dewey boasted that he ascribed to "newer" psychological theories, which claimed that children have "special impulses of action to be developed through their use in preserving and perfecting life in the social and physical conditions under which it goes on." These substantive differences in their basic assumptions about the nature of learning required fundamental differences in their respective instructional approaches.

Aside from the difficulties of attempting to redeem Dewey's educational thought, one nagging problem with Kirkpatrick's book is that while he acknowledges that the *content* of education would be "freely chosen by the education consumer in a marketplace of ideas," he doesn't concede that consumers should also freely choose the *method* of education.

There is no guarantee that parents would flock to schools that implemented educational approaches based on concentrated attention. In a free market in education, parents who want to raise their children to become confident, independent adults might find concentrated attention-based instruction a desirable alternative to existing educational approaches. Even if they don't, they should have the choice. Kirkpatrick's success is in offering them a choice worthy of attention. FEE

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The Left, The Right, and The State

by Llewellyn Rockwell
Ludwig von Mises Institute • 2008 • 553 pages • $29.00

Reviewed by George C. Leef

The Left, The Right, and The State, a collection of 103 essays by Llewellyn Rockwell, looks at the ways both the left and right use the State to pursue their goals. Rockwell, president of the Ludwig von Mises Institute, argues forcefully that our liberty and property are endangered equally by left-wing and right-wing statism. As he puts it, "The left has a laundry list and the right does too. Both represent a grave threat to the only political position that is truly beneficial to the world and its inhabitants: liberty."

Precisely. The great virtue of the book is how Rockwell shows that when people on the political right point to "liberal" increases in government power and say, "They're attacking freedom!" they are correct—as are those on the political left who point to "conservative" increases in government power and say the same thing. The problem Rockwell illuminates is that both camps are blind to the damage done by their own impulses to expand the power of the State. A massive, unrestrained government is a bull in a china shop.

Each reader will undoubtedly find certain essays especially insightful. One of my favorites is "Freedom is Not 'Public Policy.'" Rockwell argues that one of the worst errors of free-market intellectuals is their discussion of liberty as just another policy option for politicians and bureaucrats to consider. That formulation, he writes, "implies that it is up to the state—its managers and kept intellectuals—to decide how, when, and where freedom is to be permitted." He cites as an egregious example the Reagan administration's approach to tax cutting, when tax cuts were defended on the grounds that they would ultimately bring in more government revenue. We don't cherish freedom, Rockwell observes, because it maximizes the government's haul of money. Instead, tax cuts should be advanced on the grounds that it is right for people to keep and decide how to spend the money they earn.

Rockwell has sharp words for both the left and the right on the ways they have been lured by the siren song of government to abandon principles they formerly held. On the right, for example, he shows that pro-family advocates have been drawn into the big-government orbit with such nonlibertarian policies as school vouchers. He also takes aim at "free-market" scholars who propose "solutions" to welfare-state problems, such as Social Security, that merely involve some trimming of that poisonous plant, rather than uprooting it entirely.

The left also gets taken to the woodshed over issues like its abandonment of free speech in favor of restrictive campus speech codes. And what has become of the old leftist commitment to civil liberties? Today it's little more than a fading memory, with leftist politicians jumping on the bandwagon for the war on drugs, the war on illegal immigration, expansive eminent-domain powers, and so forth. The omnipotent State now tramples all over the rights of "the little guy." The left used to care, but now prefers to turn a blind eye.

After several hundred pages of razor-edged attacks on the waste, folly, and outright evils of "liberal" and "conservative" statism, Rockwell gets to the crucial question: What do we do? Examining and then rejecting various suggested courses, he argues that libertarians must work to *cultivate sound ideas*. We can make no progress against our greedy, intrusive, authoritarian government so long as most Americans accept the false idea that government action is the key to progress and prosperity.

For example, since most Americans believe that economic recessions are a natural part of the free market and we need government action to "stimulate the economy" when it turns sick, it's inevitable that politicians will support massive federal spending to cure it. We need to explain the truth about economic cycles to the public. Similarly, most Americans believe that we must have "public" education or else suffer from widespread illiteracy. We need to convey the truth that the market for education works and would deliver far better results at less cost if it were allowed to function.

Indeed—*cultivate sound ideas.* Reading Rockwell's book will help you do exactly that.

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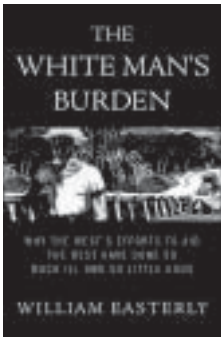

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Rule of Law versus Legislative Orders

BY WALTER E. WILLIAMS

Webster's dictionary defines law as all the rules of conduct established and enforced by the authority, legislation, or custom of a given community or group. Why are there laws in the first place? The most apparent answer is, were there not a particular law, some people would not conduct themselves according to the law in question. But is that entirely true?

For example, were there no law regarding which side of the road we should drive on, one imagines that self-interest would lead to a spontaneous emergence of a custom to drive, say, on the right-hand side of the road—at least in the United States. But there would probably be some who would drive on the left; therefore, a law, with associated penalties, is needed to enforce concurrence among would-be outliers.

There are other standards of human conduct not codified in law, such as men taking their hats off in Christian churches and wearing hats in synagogues, eating with utensils rather than one's hands, and giving the appropriate greeting. It is tempting to trivialize these standards by suggesting they are not as important as laws mandating which side of the road to drive on. But that is untrue. A nasty remark, discourtesy, or show of disrespect that is not apologized for can lead to violent conflict.

What should be the characteristics of laws in a free society? Think about baseball rules (laws). Through no fault of their own, some players hit fewer home runs than others. To create baseball justice, how about a rule requiring pitchers to throw easier pitches to poorer home run hitters, or one that would treat a double like an inside-the-park home run? Some pitchers aren't as good as others. How about allowing them to stand closer to the batter? Better yet, we could rule their first pitch to each batter a strike no matter what. In the interest of baseball justice we might make other special rules to level the playing field between old players and young players, black and white, and fast and slow.

You say, "Williams, you can't be serious! Can you imagine the conflict that would emerge: players lobbying umpires, umpires deciding who gets what favor, lawsuits, not to mention fighting?" You're absolutely right. The reason baseball games end peaceably, and players and team owners are generally satisfied with the process, whether they win or lose, is that baseball rules are known in advance. They apply to all players. They are fixed, and umpires don't make up rules as they go along. In other words, baseball rules meet the test of "abstractness." They envision no particular outcome in terms of winners and losers. Baseball rules simply create a framework in which the game is played.

> The rule of law means laws are certain and known in advance, they envision no particular outcome, and most important, laws are equally applied to everyone, including government officials.

Laws, or rules that govern a free society, should have similar features. There should be a "rule of law." The Rule of law means laws are certain and known in advance. Laws envision no particular outcome except that of allowing people to peaceably pursue their own objectives. Finally, and most important, laws are equally applied to everyone, including government officials.

Sir Henry Maine, probably the greatest legal historian, said, "The greatest movement of progressive soci-

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eties has hitherto been a movement from status to contract." In nonprogressive societies the rule of law is absent. Laws are not general. They're applied according to a person's status or group membership. There's rule, not by *legis*, the Latin word for law, but by *privilegium*, the Latin term for private law. What's lacking is the principle summarized by English jurist A. V. Dicey: "Every man, whatever be his rank or condition, is subject to the ordinary law of the realm and amenable to the jurisdiction of the ordinary tribunals."

Consider the case of a person arrested and charged with rape. Should his status—whether he's a senator, professor, or ordinary man—play a role in the adjudication of the crime and subsequent punishment? I'm betting that the average person would answer no.

Just about every law that Congress enacts violates all the requirements for the rule of law. How do we determine violations of rule of law? It's easy. See if the law applies to particular Americans as opposed to all Americans. See if the law exempts public officials from its application. See if the law is known in advance. See if the law takes action against a person who has taken no aggressive action against another. If you conduct such a test, you will conclude that it is difficult to find many acts of Congress that adhere to the principles of the rule of law.

A rule-of-law regime would require that we scrap the Internal Revenue Code in its entirety. What justification is there for the tax laws to treat an American differently because he has a higher income, minor children, or income from capital gains instead of wages? Equal treatment, at the minimum, would require Congress to figure out the cost of the constitutionally authorized functions of the federal government, divide it by the adult population, and send us each a bill for our share. You say, "What about the ability-to-pay principle?" That's just a politics-of-envy concept that would be revealed as utter nonsense if applied to anything else, such as gasoline or food.

That Americans have become ruled by orders and special privileges helps explain all the lobbyists, money, and graft in Washington. We've moved away from a government with limited powers, as our Founders envisioned, to one with awesome powers. Therefore, it pays people to spend huge amounts of money to influence Congress in their favor. Privilege-granting is precisely what most Americans want, though they might disagree on who gets what privilege. Most Americans have no inkling of what the rule of law means. We think it means obedience to whatever laws Congress enacts and the president signs. That's a tragedy.

Customs, traditions, mores, and rules of etiquette, not laws and government regulations, are what make for a civilized society. These behavioral norms, mostly transmitted by example, word-of-mouth, and religious teachings, represent a body of wisdom distilled through ages of experience, trial, and error. It's the morality embodied in those thou-shalt-nots: kill, steal, lie, cheat, and so on. The importance of these behavioral norms is that people behave themselves even if nobody's watching. There are not enough cops and laws to replace personal morality as a means to a civilized society. At best, the police and criminal justice system are the last desperate line of defense for a civilized society. Our increased reliance on laws to regulate behavior is a measure of how uncivilized we've become.

At best, the police and criminal justice system are the last desperate line of defense for a civilized society. Our increased reliance on laws to regulate behavior is a measure of how uncivilized we've become.

Twenty-five years ago, during a dinner conversation with Nobel laureate Friedrich A. Hayek, I asked if he could propose one law that would help restore, promote, and preserve liberty. Hayek answered that the law would read: Congress shall enact no law that does not apply equally to all Americans. Hayek's suggestion would do untold wonders in fostering the liberties envisioned by our Founders. But I'm betting that most Americans would greet Hayek's proposal with contempt after they realized it would mean Congress could not play favorites. FEE

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